S. HRG 101-250

AIRLINE ACQUISITIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON AVIATION

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

S. 1277

TO AMEND THE FEDERAL AVIATION ACT OF 1958 TO PROHIBIT THE ACQUISITION OF A CONTROLLING INTEREST IN AN AIR CARRIER UNLESS THE SECRETARY OF TRANSPORTATION HAS MADE CERTAIN DETERMINATIONS CONCERNING THE EFFECT OF SUCH ACQUISITION ON AVIATION SAFETY

JULY 14, 1989

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AIRLINE ACQUISITIONS

FRIDAY, JULY 14, 1989

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
SUBCOMMITTEE ON AVIATION,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:34 a.m., in room SR-253, Russell Senate Office Building, Hon. Wendell H. Ford (chairman of the subcommittee) presiding.

Staff members assigned to this hearing: Steve Palmer, senior professional staff member; Carol Carmody, professional staff member; and John Timmons, minority staff counsel.

OPENING STATEMENT BY SENATOR FORD

Senator FORD. Good morning, ladies and gentlemen. I am pleased to call to order today's Aviation Subcommittee hearing to consider the issue of airline takeovers and leveraged buyouts and to discuss the ramifications such transactions could have on our air transportation system.

Last month's $3.7 billion takeover of Northwest Airlines signaled the first venture by Wall Street into the airline industry. Other carriers, most notably United and Delta, are also being looked at by LBO investors. Let me say up front that this trend is very disturbing, for given the tenuous nature of discretionary travel, an airline laden with debt will likely face a very bumpy ride during a major recession.

Typically highly leveraged firms must take drastic steps to recover from a leveraged buyout. For an airline, this could mean selling aircraft or international routes, delaying the acquisition of new aircraft, cutting corners on safety programs or forcing employee wage reductions. These actions could have significant adverse effects on the airline industry and the traveling public.

For his part, the Secretary of Transportation is currently reviewing the Northwest acquisition proposal. However, DOT has no authority to approve such a transaction. The Secretary can only take the most extreme action to declare that new management is not fit to operate the airline and withdraw the operating certificate. This drastic step, shutting down that airline and leaving thousands of travelers stranded throughout the country, is arguably an unlikely course of action.

For this reason, Senator McCain and I introduced S. 1277, legislation to establish a framework under which the Secretary of Transportation would be required to approve airline acquisition applications. It is the job of the United States Government to ensure that our airlines are financially fit to operate at the highest level of safety. As such, a formal process must be established within the Federal Government to scrutinize proposed acquisitions, ensuring that they will not weaken or impair an airline's ability to meet existing fitness and safety standards.

I hope that our activity in this area is not interpreted to be an attempt to reregulate the airline industry or to restore DOT's authority over mergers and acquisitions. Rather, our bill is designed to provide the Secretary of Transportation with congressional guidance for making the determination as to whether a proposed acquisition of an air carrier is consistent with the public interest. It will guard against investment initiatives which contemplate the repayment of excessive borrowing through the wholesale dismantling of the carrier and its assets.

Before concluding, let me express one other concern that I hope can be addressed today by our witnesses, that being the matter of foreign investment in U.S. airlines. It disturbs me that this trend is developing without any formal policy review by our government. I therefore hope we can discuss the question of what such investments, both direct and indirect, mean with respect to the control of the U.S. air carriers.

With that, let me welcome the witnesses today, and I appreciate the willingness of those witnesses to testify in order that the subcommittee may develop a complete record on these important issues.

I am pleased that my ranking member, Senator McCain, is here. I will call on him now for any statement he might have.

OPENING STATEMENT BY SENATOR McCAIN

Senator McCAIN. Thank you very much, Mr. Chairman. I would like to associate myself with your statement. I think it describes very succinctly the situation that we face and the reason for this hearing today.

I also would like to say it was my pleasure to join you as a cosponsor of S. 1277 which would give, as you described, the Secretary of Transportation a role, simply a role, in evaluating the effect on the airline industry of proposed airline acquisition based on safety.

Mr. Chairman, as I have stated many times before, I am a proponent of airline deregulation. I am increasingly concerned about the apparent trend toward de facto reregulation. I believe that the GAO has made a convincing case and in the next hearing will make an even more convincing case before this committee that concentration has caused and is causing an increase in air fares. We should be concerned about any event which might further this trend.

It is well to note that at present our Nation's economy is performing well. History would indicate, however, that at some point we will have another economic recession. I do not believe the airline industry can undergo further contraction and remain healthy. We currently have five major healthy airlines in this country. I do not believe that five major airlines are enough. I believe we need more. I am concerned that a highly leveraged industry will not take us in this direction but, in fact, may take us in the opposite direction.

I am concerned about the effects of economic stress on airline safety. A company with declining revenues, but required to make fixed interest payments, will cut costs. An airline must have planes to fly, fuel for flight and personnel to fly the planes. This leaves service and maintenance.

Mr. Chairman, airlines are not corn flakes. If properly used and maintained, they greatly enhance our quality of life. They provide us with the opportunity to do business across the country as well as around the world, the opportunity to visit and vacation in remote parts of the globe, the opportunity to share the joy and sorrow of distant family. We must do everything in our power to keep this opportunity within reach of most, if not all, Americans. This requires us to view with skepticism and concern anything which might constrict this opportunity.

Mr. Chairman, I also share your concern about the foreign investment aspect. I think that we have seen at least three major foreign airlines investing in our domestic airlines. In the proposed Northwest acquisition, it is my understanding that KLM put up $400 million of the $700 million in cash in this acquisition. They are certainly free to do that. I am very interested in what their motives and long-term goals are as well as those of other foreign airlines who are investing in U.S. domestic airlines. I don't think we would like to see the day where all the aircraft that are flying around the world are all owned by JAL or Lufthansa.

Thank you, Mr. Chairman. I look forward to hearing this testimony of our expert panel of witness this morning.

Senator FORD. Thank you, Senator McCain. I look forward to our mutual desire here to find the right answers. And so with that, we have as our first witness this morning, Jeffrey N. Shane, Assistant Secretary for Policy and International Affairs from the Department of Transportation. Welcome, Mr. Shane, and we look forward to your testimony and your ability to answer some of our questions.

I have opening statements from Senators Pressler and Kasten that I will include in the record.

[The statements and bill follow:]

OPENING STATEMENT BY SENATOR PRESSLER

Mr. Chairman, I commend you and the ranking member of this subcommittee for your insight into leveraged buyouts and takeovers in the aviation industry. It's been less than a month since we had a similar hearing in the Surface Transportation subcommittee on LBO's in the railroad industry. Clearly, there are some legitimate concerns and questions that need to be answered before we can be confident that the public interest is being protected.

Today's hearing is as fresh as the headlines. From the *Washington Post:* "Takeover Speculation Fuels Rise in United Airlines Stock." The *Wall Street Journal* reported on Delta Airline's new employee stock ownership plan as a possible anti-takeover measure. And a recent *Minneapolis Star and Tribune* headline said. "U.S. Wants More Information on Northwest Airlines Sale."

The Post article correctly identified this situation as a "takeover frenzy engulfing the airline industry." A company showing a strong financial performance with a supposedly undervalued stock could soon be at the mercy of Wall Street investors looking to turn a quick profit.

In the meantime, the traveling public is left in the lurch. This is especially sensitive in South Dakota and other sparsely populated areas where airline service could easily be trimmed or discontinued to cut expenses.

I don't mean to single out Northwest Airlines. I have been given assurances by Fred Malek, one of the investors with Wings Holding, Incorporated, that—quote—"even if our worse case scenario should become reality, there will be sufficient cash flow to meet all debt service obligations and to continue service to all Northwest points." I take Mr. Malek at his word and hope his predictions come true. However, there still needs to be more scrutiny of these deals.

Just as I supported the Interstate Commerce Commission's broadened jurisdiction during the takeover of a railroad, I support giving the Secretary of Transportation additional power to review these airline merger transactions. I would like to be added as a cosponsor of S. 1277.

Thank you again, Senators Ford and McCain, for your leadership in this area.

Opening Statement by Senator Kasten

Mr. Chairman, I congratulate your calling this hearing on S. 1277 and leveraged buyouts in the airline industry. The explosion of LBO's in the economy generally is a subject that has received a lot of public attention lately, and their occurrence in the transportation area is a special concern. We have recently held a hearing on the same subject relative to railroads in the Surface Transportation Subcommittee.

LBO's are not necessarily bad, however in the rail and airline industries, where safety and service to the public are so paramount, they present issues which we should study. Economies instituted to pay increased debt service and asset sales which often follow such transactions raise public concerns that are not necessarily present in a Nabisco transaction.

We have seen the recent situation regarding Northwest Airlines. Though that tender offer won't close until July 21, I feel this transaction may actually improve the situation at this particular airline which has had its share of labor and service problems.

I am interested in the testimony of our witnesses today on the need for such legislation as the Chairman and Ranking Member have proposed, and look forward to working with this subcommittee in that regard.

Thank you, Mr. Chairman.

101st CONGRESS
1st Session

S. 1277

To amend the Federal Aviation Act of 1958 to prohibit the acquisition of a controlling interest in an air carrier unless the Secretary of Transportation has made certain determinations concerning the effect of such acquisition on aviation safety.

IN THE SENATE OF THE UNITED STATES

June 23 (legislative day, January 3), 1989

Mr. Ford (for himself and Mr. McCain) introduced the following bill; which was read twice and referred to the Committee on Commerce, Science, and Transportation

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A BILL

To amend the Federal Aviation Act of 1958 to prohibit the acquisition of a controlling interest in an air carrier unless the Secretary of Transportation has made certain determinations concerning the effect of such acquisition on aviation safety.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. The Congress makes the following findings:

(1) There is a direct national public interest in airline safety and reliability.

(2) The United States Government has a responsibility and an obligation, through its certification of air

carriers pursuant to section 401 of the Federal Aviation Act of 1958, to assure the traveling public of the safety and reliability of air carriers.

(3) An air carrier in seriously weakened financial circumstances may take actions designed to—

(A) reduce maintenance expenditures;

(B) avoid or reduce commitments to modernize its fleet; or

(C) avoid or reduce commitments to ground improvements at airport facilities, in order to meet its financial obligations.

(4) Air carriers with excessive debt burdens may pose an increased risk to air carrier safety and reliability.

(5) The public interest requires a review of acquisitions of control of air carriers which significantly increase air carrier indebtedness to assure that the public interest in air carrier safety and service is adquately protected.

AMENDMENT TO FEDERAL AVIATION ACT OF 1958

SEC. 2. Section 401 of the Federal Aviation Act of 1958 (49 App. U.S.C. 1371) is amended by adding at the end the following new subsection.

"ACQUISITION OF CONTROL

"(s)(1) It shall be unlawful for any person to acquire, directly or indirectly, a controlling interest in an air carrier, unless the Secretary of Transportation has made a prior determination, after notice and hearing, that the acquisition of such controlling interest will not adversely and materially affect such air carrier's fitness and ability to conduct air transportation in a manner consistent with the highest degree of safety.

"(2) Application for a determination by the Secretary under this subsection shall be made in writing to the Secretary, and shall be in such form and contain such information as the Secretary shall by regulation require. The Secretary shall issue a final order or decision with respect to a determination under this subsection not later than 90 days after the date of submission of such application.

"(3) Prior to making a determination under this subsection with respect to an air carrier, the Secretary shall consider the likely effects of the proposed acquisition upon—

"(A) the ability of the carrier to avoid any deterioration in established safety procedures;

"(B) the existing commitments and future ability of the carrier to replace aircraft in its fleet with new aircraft;

"(C) the existing commitments and future ability of the carrier to expand its aircraft fleet through the purchase or lease of new aircraft; and

"(D) the ability of the carrier to continue to meet its commitments to maintain and improve airport and related ground facilities.

"(4) The proponent or proponents of the acquisition of a controlling interest shall bear the burden of proving that the proposed acquisition will not adversely and materially affect the air carrier's fitness and ability to conduct air transportation in a manner consistent with the highest degree of safety. If the Secretary determines that the proposed acquisition would adversely and materially affect the carrier with respect to one or more of the factors set forth in paragraph (3), the Secretary shall issue a determination disapproving the acquisition.

"(5) As used in this section, 'controlling interest' means, with respect to an air carrier, direct or indirect ownership of 25 percent or more of the voting stock of such air carrier.".

○

STATEMENT OF JEFFREY N. SHANE, ASSISTANT SECRETARY FOR POLICY AND INTERNATIONAL AFFAIRS, DEPARTMENT OF TRANSPORTATION

Mr. **Shane**. Good morning, Mr. Chairman, Senator McCain. It is a delight as always to be here and, specifically today, to discuss the potential significance of the financial market phenomenon known as the leveraged buyout, or LBO, for the Nation's major airlines.

The LBO, as a tool for corporate acquisition or takeover, has become popular during the past 10 years. Up to now, however, almost all of the acquisitions and mergers in the airline industry have been consummated without the use of LBOs. Airline corporate management for the most part has not been affected by outsider takeovers via the LBO mechanism.

The picture, though, is rapidly changing. About a month ago, as we have heard this morning, NWA, Incorporated, the parent of Northwest Airlines, announced that it had entered into a merger agreement with Wings Holdings, Inc. This transaction appears to be an LBO type acquisition of Northwest Airlines, the Nation's sixth largest carrier in terms of domestic revenue passenger miles. Wings has begun to file data with the Department of Transportation relating to the continuing fitness and citizenship of Northwest under the proposed transaction. Consistent with our established procedures in continuing fitness cases, and in view of the LBO issues raised, we have also requested additional information about the transaction. Since the case is still under review, I hope that you will understand that I simply will not be able to comment very specifically on the merits of that acquisition *per se.*

The Northwest buyout is almost certainly a harbinger of future LBO attempts in the airline industry. Several other airlines with strong balance sheets and conservative managements may well become targets of LBO attempts in the near term if they aren't targets already.

Such fundamental developments should be of concern to all of us charged with oversight of the world's greatest and safest air transportation system. At the Department of Transportation, we have been considering the basic questions raised by this phenomenon with great care and with the advice of others, including other government agencies with special insight and expertise in the area.

There are, to start with, widely ranging opinions on both the perceived benefits and drawbacks of LBOs. For example, some observers tell us that under most circumstances, debt leveraging can dramatically enhance competitive behavior. A leveraged company must become more efficient to deliver the cash flow necessary to service its increased debt and to create a profit for the owners.

Often marginal operations, unprofitable divisions and unrelated businesses or properties are sold off or eliminated. This allows the transformed company to focus its attention on those operations in which the company has competitive advantages and strengths, making it a stronger and more aggressive competitor overall. In this connection, new owners and fresh management may improve the corporate image, service and operating efficiency of the company. Lastly, because ownership of a company that has gone through a leveraged buyout is usually closely held, some argue that the owners may be in a better position to demand better management performance and ensure that the firm's value is maximized.

There are, of course, strong views about the down side to leveraged buyouts, especially in an industry as cyclical as air transportation. Servicing a huge debt can be potentially debilitating and restrictive. If there were a series of LBO type acquisitions resulting in a number of indebted carriers with the diminished capacity to attract new capital, acquisition of newer advanced aircraft might be more difficult. Moreover, these carriers might have a decreased financial capability to expand and help renovate needed airport facilities.

How likely is this scenario and to what degree might air service eventually suffer? This is the question we at the Department of Transportation are wrestling with right now.

At this point let me emphasize that the more negative scenario is not a prediction, and we are not at this time advocating any new legislation or regulation to address these concerns. What we are saying is that we are currently in the process of examining carefully the likely impact LBO transactions would have on the air transportation system. If and when we conclude that there is a problem, and that government remedies are indicated, you can be sure that we will pursue those remedies with determination. To the extent that we felt that our statutory authority was deficient, we would certainly seek Congress' help in beefing up that authority.

If these comments seem to be erring on the side of caution—and you will see that they do err on the side of caution—it is simply because we cannot responsibly advocate government intervention in essentially private market-driven decisions prior to the completion of our review of this complicated issue. The crux of the matter, as I said earlier, is the degree to which a heavy debt burden may impair the functioning of an air carrier and eventually of the air transportation system. On the basis of what we know today, we believe that it would be premature to conclude that the debt burden resulting from an LBO would, *ipso facto*, impair the ability of the airline in question to maintain fit and efficient operations. Again, because some experts believe LBO's actually increase operating efficiency, we should proceed cautiously. We do not believe that the subcommittee should act further on legislation along the lines of S. 1277 until we have answers to the fundamental questions.

We recommend caution with a confidence that derives from the effectiveness of our existing authority. Congress has already provided the Department the wherewithal to review the fitness of air carriers, and we intend to use that authority aggressively to examine the likely effects of LBO's on individual airlines. The fitness review procedures set forth in section 401 of the Federal Aviation Act serve both as a means of looking at prospective applicants—aspiring new entrants—and as a means of assuring the continuing fitness of incumbent carriers. The latter procedure is directly relevant to circumstances in which a carrier undergoes substantial changes in its ownership and financial position.

As you may be aware, we have three separate elements in our fitness review process: management competence, financial condition, and what we call compliance disposition. We also review the citizenship of the carrier. These procedures enable us to scrutinize carefully a given LBO transaction to determine whether it is likely to be detrimental to the carrier and, as a consequence, damaging to the airline industry in general.

We can require a fitness review in connection with any transaction that will result in a significant change in a carrier's operations, management or financial condition. This, of course, includes any large scale sale of slots, gates, aircraft or international routes. Secretary Skinner has made clear his determination that the Department will play an active role in the disposition of governmentally bestowed authorities such as international routes.

I might just say, Mr. Chairman, in light of statements at the outset of the hearing, that it is not entirely clear that the only remedy that the Department of Transportation has is to shut down the airline in the event that a proposed LBO transaction did appear to be prospectively detrimental. We are pretty clear that in reviewing, for example, the Northwest transaction, were we to determine prospectively that Northwest Airlines, post-transaction, would not be a fit airline within the meaning of the Federal Aviation Act, and we determined that that is what our finding would be, it is our conviction that that transaction simply would not be consummated. That is what the financial community tells us. That is why the financial community has its mind concentrated wonderfully on the Department of Transportation right now. We are pretty confident that we do, in fact, have authority that is more tailored than the most draconian interpretation of it, the actual shutdown of Northwest.

Senator **FORD**. At that point, let me just ask you this question Mr. Shane. Would you be able to stop the acquisition by jawboning or do you have statutory provisions that would turn it around?

Mr. **SHANE**. It is not a statutory provision as such, beyond the fitness review process that is embodied in the statute. What I am saying is that if we simply let it be known that on the basis of our analysis of a particular transaction we would find that the post-transaction carrier not fit to be in the airline business, the lenders would head for the hills. That is what I am saying.

Senator **FORD**. If they did not, what would be your recourse then?

Mr. **SHANE**. Well, if they did not, if they continued to push the transaction, then we would have no alternative under the law but to withdraw the certificate from the airline.

Senator **FORD**. That's the only leverage you have then, isn't it, other than jawboning?

Mr. **SHANE**. If the financial community insisted on consummating a transaction that made no sense, you're right.

Senator **FORD**. The transaction might make no sense to you but maybe it makes sense to them. You know, there is a difference. A lot of people are putting money in. You make a judgment it is not fit and they make a judgment to continue forward. Then the only alternative you have is to withdraw the certificate.

Mr. **SHANE**. Well, that would be the case, undoubtedly, if they consummated a transaction knowing that the airline would be unfit as a result of the transaction.

Senator **FORD**. You mean unfit in the definition or the interpretation of the Department of Transportation.

Mr. **SHANE**. Yes.

Senator **FORD**. I didn't mean to interrupt you, but I thought it was a point we ought to make so that you and I would be on the same wavelength.

Mr. **SHANE**. Yes, sir.

Senator **FORD**. The jawboning is one thing and the statutory ability is another.

Mr. **SHANE**. Well, I would characterize it as something more than mere jawboning because of the statutory authority we now have to withdraw a certificate. That is jawboning with a certain amount of leverage.

Senator **FORD**. I understand.

Mr. **SHANE**. Finally, I wanted to mention one additional tool which we shouldn't overlook and that is that we can recommend to the Department of Justice, under its Hart-Scott-Rodino review authority, that it block on antitrust grounds any asset sale or airline acquisition that involves another air carrier if we believe that the result would be anti-competitive.

Let me add that the DOT staff is currently working on a comprehensive study of competition in the airline industry. We expect that the study will be completed by mid-October, and along with our current in-progress review of the impact of LBOs, we believe that we will then have a better perspective on the LBO situation. If necessary, we will be far better prepared to fashion an informed and reasonable response to the effects LBOs may present. In the interim, however, we feel that the tools currently available are adequate to deal with the circumstances presented by potential LBO acquisitions.

Mr. Chairman, you and the subcommittee are to be congratulated for recognizing so quickly the importance of exploring the potential effects of LBOs on the airline industry. There can be no question but that the LBO phenomenon could have potentially serious consequences for that industry. You may be sure that the Department of Transportation is examining the phenomenon very closely as well and that we will be more than happy to work with the subcommittee as our inquiry proceeds.

Mr. Chairman, that concludes my prepared statement, and I am certainly happy to answer any questions that you may have. Thank you.

Senator Ford. Thank you, Mr. Secretary.

If the Department determined that new management in an airline takeover was not fit to operate and the financial package moved forward with considerable amount of foreign investment up to the 25 percent I guess, would you in fact pull the certificate if you found that in your judgment that they were unfit in, as you say, post-transaction operations?

Mr. Shane. I think we are hypothesizing that we are looking at a carrier as it would appear after the transaction, but we are looking at it before the transaction. Do I understand the question correctly?

Senator Ford. Yes, that is correct. You are making a judgment prior to the finalization of the transaction as to what will occur after it is consummated.

Mr. Shane. If it was our determination, on the basis of the material filed, that the management proposed for the airline was not fit, we would have, it seems to me, both a statutory and a moral responsibility to inform the owners that that would be our conclusion. And I presume that adjustments in the transaction would rapidly be made.

Senator Ford. How far along is your study that you mentioned would be available in October? Is there any way to accelerate that?

Mr. Shane. It is on about as fast a track, Mr. Chairman, as we can reasonably put it on. The first portion of the study has been circulated just the other day to an assortment of other government agencies that follow competition issues closely, and I believe that there is reasonable satisfaction with that first phase of it, but it is hard for me to imagine how we could crank it up any faster than it is already going. Secretary Skinner, as I think you know, has made it a major priority of his and when he has a priority, he lights a fire under his staff the likes of which you have not seen very often.

Senator Ford. Would it be possible for Senator McCain's staff and mine to have the copy of the paperwork as it proceeds so that we could kind of stay along with you and understand the background, changes, input, corrections, et cetera?

Mr. **SHANE**. We would be delighted to work with you in sharing within reason what can be shared without compromising the speed with which we are going forward.

Senator **FORD**. Well, if you are circulating papers among various departments, you could just add the staff here so that we could have a copy of those papers at this department. It would be very simple just to send a paper on over here. I do not think it would jeopardize the speed. We do not want to jeopardize any of the comments or contents of the papers either, but once you start spreading them around through departments, there is very little left unknown.

Mr. **SHANE**. A fair statement, indeed.

Look, the spirit certainly is that we want to share as much as we can as soon as we can, and I would be delighted to sit down with the staff and see what we can work out.

Senator **FORD**. I think our spirit and intent here is to try to find something that would be adequate and would give you proper review and proper positions that you could take under policy positions that we feel—at least I feel—that you do not now have. I think it is pretty harsh.

I can see how you could stop a transaction without lifting their certificate, and that is just so much pressure brought upon those who are going to finance it. But there may be a route after 1992 in Europe when foreign nations might want to take a short-term loss in order to buy into a U.S. carrier so they would be in position to be better positioned after the routes are re-negotiated. So, there is little more madness to the method here than may be showing up on paperwork.

You discussed how in an LBO marginal operations are typically sold off or eliminated. Given the nature of the airline industry, why wouldn't this mean that the highly leveraged carrier would drop service to marginal or smaller profitable communities?

Mr. **SHANE**. Well, I guess I was talking about the difference between non-airline elements in a company that is mainly in the airline business and the core business, which is to say the airline business of that company. And I think of Allegis Corp., for example, which was United Airlines grown into a multi-faceted industry with car rental companies and hotels and the like. The decision of United's management when it went through the most recent restructuring was to slough off the car rental company, the hotel company and so forth, and get back to the core business, concentrating all of its energies on the airline business. That is the kind of marginal operation, unessential operation, that I was talking about.

There isn't any compelling reason why a company with marginal airline routes would keep them going under any scenario that I can envision. So, I don't see that it would take an LBO to withdraw those kinds of marginal services. Those happen, it seems to me, just because of what any airline management would automatically do. I don't see, therefore, the withdrawal of marginal routes as being a consequence of LBOs. That is another problem. We have to deal with that problem in some cases, but I do not see it being a new product of this new financial transaction affecting the airline industry.

Senator **Ford**. I can see a small community that is marginally profitable to major airlines and commuter service, that under the present circumstances would continue to operate, but in an LBO each of those would be dropped because there was no profit. This service to small communities would go by the wayside very quickly. That would be my judgment, and that differs from yours somewhat.

Mr. **Shane**. No. Certainly if there were marginal routes, then I suppose any new management coming in would take a very hard look at what the airline was doing and would be inclined to try to maximize profit, which would mean in some cases dropping marginal routes. But I think that is likely to happen with or without an LBO.

Senator **Ford**. Dropping marginal routes is more suspect under an LBO than it would be under normal circumstances I think. So, we won't get into our——

Mr. **Shane**. Well, I am not disagreeing with you. I think it could happen, but I don't see that as being peculiar to the LBO transaction.

Senator **Ford**. In S. 1277, we direct the Secretary to consider four aspects of airline acquisition: commitments to safety, number one; the purchase of new aircraft; the purchase of replacement aircraft; and airport improvements. Are there other items that should be added to that list?

Mr. **Shane**. Well, commitment to safety is certainly something that we insist upon right now. There can't be any question about that. And it is not a subjective commitment that we are looking for. We are looking for performance on the ground and in the sky. And that is why the FAA is looking as closely as it is at all airlines.

Getting into more subjective commitments like a commitment to refurbish the fleet on a particular schedule or build new airport facilities becomes a tougher statutory standard to administer, and to the extent that we went further than that, getting into other areas, it would be hard for me to know precisely what the Department of Transportation's staff would develop by way of criteria. You would end up, it seems to me, encouraging wild statements from airline management about what they were planning to do in the future, promises that nobody would ever be able to hold them to in the longer term because of the vicissitudes that we are used to seeing in this industry.

So, I guess if you ask my advice as to what the bill ought to contain, if you are determined to provide an up or down call at some point on the part of the Secretary of Transportation regarding an LBO transaction, I would say make that call be a function of the fitness criteria that are already in the Federal Aviation Act. They are time honored. They work. The industry knows what they mean. There is a common law, if you like, of fitness reviews which everybody in the business is now familiar with.

Senator **Ford**. You say a common law?

Mr. **Shane**. Yes, because we have had so many fitness reviews over time.

Senator **Ford**. Why wouldn't you just transfer that into statutory law?

Mr. **Shane**. Well, as in so much of the common law, it is a function of statutory law. I talked in my prepared statement about management competence, about financial fitness, and compliance disposition. Those elements are elements that have been imported into the law by, if you like, the regulatory process. What the statute said is that an airline must be "fit, willing and able" to perform the service that it is licensed to perform. We have expanded on those criteria through the regulatory process to the point where we now have these three central elements, and those three central elements are well understood.

Senator **Ford**. Well, anything you can put on by pen can be taken off by pen.

Mr. **Shane**. Well, there is no prospect of anyone at the Department of Transportation reducing the stringency of those criteria.

Senator **Ford**. What about adding impact on the work force?

Mr. **Shane**. The advice that we are getting is the same kind of advice we are getting on other aspects of the LBO transaction.

If you think LBOs are good, you will think that LBOs are good for the work force. If the company becomes more competitive, if it expands with the amount of new capital available, even though that capital is available in the form of debt, then there will be more jobs. It will become a more efficient airline. It will become a more advanced airline and an aggressive airline. And labor can only benefit from that scenario.

If you are convinced that an LBO is a disaster for the airline and that the net result of an LBO transaction with all of that debt servicing obligation is to shrink the airline, then labor will be affected along with everyone else. And you would be concerned about it.

How you embody a question of that kind in a statute is, in my mind, a very difficult question. I wouldn't know how to do it.

Senator **Ford**. You know, all questions are difficult and everybody has to make a judgment. We keep the record here to show the lack of judgment of Congress. So, we just have to make those decisions.

What you are saying to me, as I interpret your conversation, is that there is a prejudgment: either you say LBOs are good or they are bad. If you say they are good, they are going to expand and everything is going to be good. If you say they are bad, why then everything is going to be bad. I do not think you can make that kind of judgement, and I do not think anyone should be able to make that kind of judgement. And that is not our intent here.

Mr. **Shane**. I think, Mr. Chairman, if we felt that an LBO was bad in terms of the normal fitness criteria and rejected the transaction, or rejected the post-transaction airline, on the basis of the fitness criteria, what we would be saying is that, naturally enough, the effect of that transaction on labor would be equally bad. And to the extent that our action was effective in discouraging that transaction, labor would benefit from that action.

If an LBO passes muster on the basis of fitness, it would be my judgment that it ought to pass muster at the same time, *ipso facto*, as being good for labor. We would see the transaction as being essentially good for the airline, making it a better, more tightly managed, more aggressive and more competitive company. And that is what labor is after.

Senator **Ford**. Let's move on to a couple of other areas, and I do not want to take too much time away from Senator McCain.

What are your views on foreign carriers or entities acquiring part of a U.S. carrier and how will this factor into your evaluation of airline acquisitions?

Mr. **Shane**. In the first instance, of course, we are governed by statute. There is a maximum voting control that is permitted to foreign carriers, which is 25 percent. As a regulatory matter, we begin to look very hard at the transaction once a foreign air carrier begins to have about 10 percent voting control of a U.S. carrier.

There is another criterion as well: a foreign carrier may not have more than a third of the directors or officers of a U.S. registered air carrier.

We have foreign air carriers investing in U.S. air carriers already. I think Ansett, an Australian carrier, has about 20 percent of America West. Japan Airlines just picked up about 20 percent—it may have been through a subsidiary, but it's essentially Japan Airlines—20 percent of Hawaiian Air. SAS has bought about 9 percent of the stock of Continental, I understand. And Swissair, I think, just this week has purchased 5 percent of the stock of Delta.

Nothing in the statute suggests that there is anything inherently wrong with those acquisitions. It is a source of capital, in these cases equity capital, which we can't complain about very much.

We worry, I guess, to the extent that foreign airlines begin to exercise something like real control over U.S. carriers. That control, I should say, is not necessarily a function of voting control or directors. I have seen examples of foreign air carriers who were in the process of acquiring what I would call real control over a U.S. air carrier with not one share of stock in that carrier, just by offering a cash infusion, just by offering some help at some point. And we begin to see U.S. airline management jumping to the tune of the foreign air carrier. That worries us. The control issue is the central one. Quite apart from the numerical criteria in the statute, we want to know whether there is control.

It is public knowledge, and I guess I can refer to it, that in the Northwest transaction, which has of course triggered the concern most recently, KLM is investing something like $400 million and that KLM's share of the remaining equity in this corporation after the transaction will be very substantial. More than half of the equity will be KLM's money.

The voting control that KLM is purchasing for that is tiny. They are getting less than 5 percent, I understand, of the voting stock of the company. They will get one member of the board of directors. One member of the 12-member board will be a KLM official. So, based on that surface review of the transaction, you would say I suppose there isn't any control. You do not object, therefore, on the basis of the pure statutory criteria to KLM investing in Northwest to that extent.

The more interesting inquiry, however, is what exactly is the relationship between KLM management and the post-transaction Northwest management. Can we say, after taking a hard look at that investment, that there will not be control in KLM? I do not want to make a prediction one way or the other because we simply do not know right now, but that is certainly a very big part of what we are looking at.

Senator McCAIN. Mr. Chairman, let me follow up.

Senator FORD. Sure.

Senator McCAIN. In your view, with your long experience, particularly on the international side of this issue, what is the motivation for these airlines all fairly recently making a sizable investment. My information says as far as return on investment, there are other investments they could make which would give them substantially higher returns? What is their motivation in your view for this recent sizable investment from a variety of different major foreign airlines?

Mr. SHANE. Well, Senator Ford referred to 1992. I believe that European airlines are trying to solidify their position in anticipation of a brave new world of international aviation, the dimensions of which are not completely understood right now. I think that is why SAS—SAS didn't only go after a piece of Continental, they were after—I don't know if they consummated the deal—a piece of Aerolineas Argentinas. They have been looking for other foreign carriers to acquire pieces of.

We are seeing cross-border mergers being discussed within Europe. There is a tremendous amount of ferment in the financial structure of foreign airlines in particular, and we are beginning to see some of that ferment now spill into the United States as foreign airlines seek a foothold in the trans-Atlantic market stronger than the one they would have had under the normal bilateral relationship that they have with the United States. And they are seeking that foothold through the mechanism of hard investments in U.S. air carriers.

It may be a bet. They may be betting on the come. If, indeed, it turns out that Europe does liberalize the structure of its airline industry and it turns out that we end up with a very big negotiation with Europe that opens up the trans-Atlantic market to a greater extent, as Jan Carlsson, the President of SAS, said one time, we are going to have a new kind of Darwinism. It will be survival of the fattest. I think KLM is trying to become fat. It doesn't have an indigenous market of its own. It basically carries Europeans from all parts of the continent over Amsterdam to the United States. It carries Americans via Amsterdam to all parts of Europe. Without that indigenous market, they need something else. That would be my analysis, and that something else is a piece of Northwest Airlines.

Senator McCAIN. Thank you, Mr. Chairman. I think that was an important point.

Senator FORD. Sure. I think it is fine, and I do not object to your moving in at any time.

Maybe you have already answered it, but let's travel over this territory. It seems that when foreign carriers acquire a portion of a U.S. carrier that operates in an international route, that foreign carrier would potentially reap dual benefits. In your view what effect would this have on future bilateral negotiations for international routes?

Mr. **Shane**. Well, if we thought that KLM's acquisition of a U.S. carrier or a piece of a U.S. carrier would affect competition between KLM and that U.S. carrier, first of all, we would want to try to figure out exactly who we have flying international routes head to head with KLM, and we might want to make some adjustments there to ensure that there were competitive services on those international routes.

But increasingly what you are seeing is a series of joint venture arrangements between foreign airlines and U.S. airlines—even some with no investment. For example, British Airways and United Airlines have been in a joint venture now for some time in which they basically hand passengers off to each other. British Airways carries its passengers from London to Chicago and hands those passengers off to United Airlines. Those passengers continue to carry tickets that say British Airways on them, but then they go on to Seattle on United Airlines. It is called a code-sharing arrangement.

It may very well be that Northwest and KLM will be in the process of working out code-sharing arrangements whereby KLM can code-share into the United States and Northwest Airlines can, using Amsterdam as a hub, code-share with KLM for more effective penetration of the rest of the European continent. In order to do that, I suspect we would have to have a lot of bilateral agreements in place that would permit those kinds of arrangements to be effective. But in some cases, we already have those arrangements, and in other cases, I would think that there is plenty of negotiating coin there.

Senator **Ford**. To your knowledge, are U.S. investors able to acquire portions of foreign air carriers?

Mr. **Shane**. I believe they are. In fact, I think—we may want to try to get something for the record on this, but my guess is that we probably have more restrictions on foreign ownership of our airlines than any foreign government has for ownership of their airlines. Now, you have government-owned airlines in some countries, of course. I am sure that it is not easy to buy a piece of a government-owned airline unless the government decides to privatize it. But I think that we have at least the amount of wherewithal to purchase pieces of privately-owned foreign airlines that they have to purchase parts of ours.

Senator **Ford**. Mr. Secretary, I am not as knowledgeable of the entity as you are, but I have some concern that your position is not totally accurate. We run into country-owned companies. We listened to testimony concerning foreign investments in a hearing here the other day and we listened to many people, including Boone Pickens who has changed his speech I think about free trade. But would you supply an answer to my question for the record after you have scrutinized the Department of Transportation's position or statutory authority?

Mr. **Shane**. I would be happy to, sir, yes.

[The following information was subsequently received for the record:]

DEPARTMENT OF TRANSPORTATION

ASSISTANT SECRETARY OF TRANSPORTATION FOR POLICY AND INTERNATIONAL AFFAIRS

REPORT ON FOREIGN GOVERNMENT REGULATIONS GOVERNING OWNERSHIP AND CONTROL OF NATIONAL AIRLINES

SUMMARY

A survey of 32 countries, which includes the major U.S.-foreign air transportation markets, indicates that most countries allow foreign investment in their airline industry either up to a specified percentage or to a point where majority ownership and control continue to reside in their nationals, or both. Each country's policy is described below.

Of the 32 countries surveyed, five (Belgium, Portugal, South Korea, Sweden, and Venezuela) appear to permit no foreign investment in their airlines whatsoever, and one other (Greece), although theoretically permitting up to 49 percent foreign ownership, effectively inhibits foreign investment. Of the remaining 26 countries, eight have no fixed limit on foreign ownership shares, 17 allow foreign ownership of 25 percent (the U.S. limit) or greater, and one (Brazil, which limits foreign ownership of voting stock to 20 percent) permits less than 25 percent. Instead of or in addition to fixed foreign ownership limits, at least 11 of the 26 that permit foreign investment require that effective control of their airlines remain under the control of their own citizens.

AUSTRALIA

Under current Australian legislation, the state-owned airlines, Qantas and Australian Airlines, may not be privately owned. Private ownership of an Australian international carrier is prohibited. Foreign ownership of privately-owned domestic carriers is permitted, subject to approval of the Foreign Investment Review Board (FIRB). FIRB would probably approve most foreign investment holdings, as long as they do not give control of interstate operators to foreign nationals. However, Australia will deregulate its domestic airline industry on October 31, 1990. After that date, proposals by foreign interests to establish new businesses or to take over existing business in the civil aviation industry above certain monetary limits will be approved by the FIRB unless judged contrary to the national interest. Foreign airlines operating services to Australia may not invest more than 15 percent in any one domestic operator. Qantas, Australia's international service carrier, apparently is also prohibited from controlling domestic Australian feeder lines.

AUSTRIA

Foreigners may invest in all Austrian airlines so long as the majority share is owned by Austrians. Any individual who wishes to establish an airline in Austria must be an Austrian citizen. Where ownership is not by an individual, the airline must have its headquarters in Austria and it must be majority owned by Austrian citizens.

BAHAMAS

There are no specific laws restricting ownership or control of Bahamian air carriers, but it is the policy of the Government that Bahamian carriers should be substantially owned and effectively controlled by Bahamian nationals. This policy effectively limits non-Bahamian participation to a minority level of not more than 40 percent.

BARBADOS, DOMINICA, ST. LUCIA, ST. VINCENT

Foreign citizens and airlines may invest in host air carriers without limitation or establish new carriers.

BELGIUM

Sabena has an effective public monopoly with regard to air transport in Belgium. The Government of Belgium is introducing a draft bill into Parliament to allow KLM and British Airways to own 20 percent each of Sabena. The draft bill continues to exclude the possibility of other Belgian airlines being formed to compete with Sabena.

BRAZIL

U.S. citizens and airlines may invest in air carriers in Brazil up to 20 percent of voting capital but may not have management control. There is no restriction on foreign ownership of non-voting capital, as long as the firm's charter prohibits conversion of non-voting shares to voting shares. Non-voting capital is limited to two-thirds of the total capital. Government-owned VASP, a domestic carrier, is being privatized and is seeking foreign investment up to the 20 percent ceiling. In addition, VASP's president has publically expressed interest in establishing an association with a foreign carrier to boost management expertise.

CANADA

Non-Canadian citizens and airlines may invest in up to 25 percent of the voting interests of a Canadian airline, providing such investment does not constitute *de facto* or effective control of the air carrier. The Canadian government is likely to view any holding of 10 percent or greater by one foreign individual as constituting *de facto* control. As long as foreign holdings are broadly spread, however, ownership of up to 25 percent would normally be permitted. Formerly government-owned Air Canada reached its 25 percent foreign ownership ceiling in May 1989. Most of the foreign interest is believed to be held by U.S. investors.

COSTA RICA

Foreign entities may invest in up to 49 percent of the capital of Costa Rican airlines. To have the right to operate, a Costa Rican corporation must be owned by Costa Ricans and the effective control and management of the corporation must be in the hands of Costa Rican citizens. Foreigners are prohibited from sitting on the Board of Directors of the airline. LACSA, Costa Rica's only major airline, is currently 49 percent-owned by Japanese interests.

DENMARK

Foreign citizens or airlines may not directly own or exercise control over aircraft registered in Denmark. While this does not preclude foreign portfolio-type investment in Danish air carriers, Danish officials state that a foreign majority investment in a Danish-controlled air carrier would not be acceptable and that such a carrier would not be granted a permit to operate commercial airline service. The Danish Government owns 50 percent of Danish Air Lines (DAL), which in turn owns two-sevenths of SAS. The other 50 percent of DAL is freely traded on the Copenhagen stock exchange.

DOMINICAN REPUBLIC

Dominicans must hold a controlling interest in Dominican airlines. U.S. citizens and airlines may invest in passenger or cargo airlines incorporated in the Dominican Republic provided their participation does not exceed 49 percent. "Air carrier ownership contracts" between Dominican and foreign entities are subject to the approval of the Dominican Civil Aviation Board.

FRANCE

Domestic investors in the air transport sector must have majority control.

GERMANY

German investors are required to have effective control of German air carriers. Ministry of Transport officials interpret effective control meaning that German investors must control at least (a) 75 percent of a scheduled carrier, limiting foreign ownership up to 25 percent, (b) 51 percent of a non-scheduled carrier, limiting foreign ownership to 49 percent.

GREECE

Foreign investors may own up to 49 percent of the shares of a Greek airline. However, the government discourages competition with government-owned Olympic Airways, effectively inhibiting any significant foreign investment.

HONG KONG

Any foreign citizen or airline may acquire an equity interest in a Hong Kong airline as long as the entity first establishes a firm incorporated in and having its main place of business in Hong Kong. A U.S. citizen or airline could acquire up to a 100 percent equity interest in a Hong Kong airline by establishing a Hong Kong company whose main business would be to hold equity in the airline.

IRELAND

General policy is that substantial ownership and effective control of Irish airlines should be in Irish hands. Irish authorities are prepared, in principle, to permit foreign capital participation in Irish airlines subject to approval and reciprocity with the country concerned.

ISRAEL

Israelis must own two-thirds of any Israeli airline, and two-thirds of the members of the airline's board of directors must be Israeli citizens. At present, there is no foreign investment in Israeli airlines. However, El Al, the Israeli national carrier, has announced its intention to privatize a 24.9 percent share. Foreign (including U.S.) ownership of the 24.9 percent public share would be welcomed.

ITALY

Foreigners may invest in Italian air carriers, but such foreign capital investment is limited to 33 percent.

JAMAICA

There are no fixed restrictions on foreign investor participation in Jamaican airlines, but in order to obtain a Jamaican license an airline must have substantial ownership and effective control by a citizen of Jamaica or a corporate body registered in Jamaica. (This requirement may be waived with ministerial consent). The Government of Jamaica is considering full or partial privatization of government-owned Air Jamaica.

JAPAN

Foreign capital investment is limited to 33 percent of Japanese air carriers. Foreign interests currently hold less than 5 percent of each of the Japanese carriers.

KOREA

Foreign investment in a Korean airline would be unlikely (if not impossible) because, first, aircraft registered in Korea may not be owned by a business that has more than 49 percent foreign equity participation, and second, the Ministry of Finance's "Guidelines for Foreign Investment" specify air transport carriers as an industry prohibited to foreign investors.

MEXICO

Mexican policy is in a state of flux. It appears that new regulations will now allow foreigners or foreign companies to own a minority position in a Mexican transportation company through a trust fund arrangement where the trustee is a Mexican banking institution. It is not clear whether the trust mechanism will prevail over the restrictions on foreign participation which is written into the General Law of Communication and Transport. Recently, the government of Mexico allowed a group of private Mexican investors to join a group of foreign, including U.S., investors to acquire control of Mexicana de Aviacion, Mexico's largest airline.

NETHERLANDS

U.S. citizens and airlines are free to invest in Dutch air carriers, but under Dutch law a carrier flying under a Dutch license must be substantially owned by Dutch nationals. Dutch law does not define what specific percentage constitutes substantial Dutch ownership.

NEW ZEALAND

There are no specific legal restrictions on foreign investment in New Zealand airlines. Investments over a certain level must be approved by the Overseas Investment Commission. In practice, the Ministry of Transportation policy is to require that any international carrier be substantially owned and effectively controlled by New Zealand nationals. This policy has been further interpreted to mean at least 65 percent New Zealand ownership. At present, 34.9 percent of Air New Zealand is owned by a foreign consortium, including participation by U. S. investors.

NORWAY

Norwegian law states that no more than 33 percent of an airline incorporated in Norway may be foreign-owned, although there is a provision for exemptions from this rule for unusual and special circumstances. SAS is a consortium owned by Norway (2/7), Denmark (2/7), and Sweden (3/7). The Norwegian share is controlled by a holding company, which is 50 percent government owned and 50 percent privately owned. The firm's bylaws limit total foreign participation to 25 percent, or one-half of the privately owned stock.

PHILIPPINES

Foreign participation in Philippine air carriers is restricted to 40 percent equity. The Philipine government is planning on privatizing PAL, and would probably welcome foreign participation up to the 40 percent ceiling.

PORTUGAL

Portuguese law specifies that ownership of scheduled air transport will be by the Government of Portugal. However, the Government of Portugal plans to privatize the national air carrier TAP by 1991. Forty-nine percent of the shares will be offered to the public with foreign investment restricted to 5 percent of that figure.

SPAIN

There are no regulations that absolutely limit the percentage of foreign ownership of Spanish airlines. The Law on Air Navigation permits up to 25 percent foreign ownership of Spanish carriers, but allows higher percentages under special circumstances and if deemed in the national interest.

SWEDEN

Foreign citizens or airlines who are not permanent residents of Sweden may not invest in Swedish airlines. There is an exception for SAS, which is a tri-national carrier whose ownership is shared by Sweden (3/7), Denmark (2/7), and Norway (2/7). Within each of the three countries, 50 percent of the ownership is held by the state and the remainder by private interests.

SWITZERLAND

Swiss law permits foreign capital participation in Swiss air carriers up to thirty percent. Board and management may not consist of more than one-third foreign citizens. Swiss authorities are considering liberalizing these ceilings to 40 percent foreign interest.

TAIWAN

Foreign investment in Taiwanese air carriers may not exceed 33 percent.

UNITED KINGDOM

Under the Civil Aviation Act of 1982, if the Civil Aviation Authority is not satisfied that an applicant for an air transport license is a UK national, or a body controlled by UK nationals, the license may be granted only with the consent of the Secretary of State. A similar provision applies to the continued holding of existing licenses by an airline which comes under foreign control. In practice, the British apply a 25 percent rule of thumb to determine which licenses need to be referred to the Secretary of State for decision. Several U.K. carriers, such as Britannia Airways and Monarch Airlines, are now owned or controlled by non-U.K. citizens.

VENEZUELA

While Venezuelan civil aviation law does not specifically prohibit foreign ownership of Venezuelan airlines, Andean Pact regulations prohibit foreign ownership in transportation enterprises. Venezuela has implemented these regulations.

Senator **Ford**. All right. I would like for you to do that.

Is there any chance your October date will slip on your study?

Mr. **Shane**. I can tell you that heads will roll if it does.

Senator **Ford**. Wonderful. Let's stop right there.

By golly, that's the way I like it.

Senator McCain.

Senator **McCain**. Thank you, Mr. Chairman.

Just a follow-up while we are on the subject of this foreign investment in U.S. airlines. I would anticipate that you would do some kind of policy analysis on this issue. Is that true?

Mr. **Shane**. Yes. It may very well emerge as one of the most important parts of, for example, the Northwest transaction for purposes of our analysis. And, yes, it requires a heads-up policy analysis. It is a phenomenon that is coming on like a train and we have to know what we think about it.

Senator **McCain**. The subject of this hearing, as you well know, is the subject of acquisitions and not mergers. But as mergers have an effect of reducing competition over time, so might acquisitions. Would you agree with that?

Mr. **Shane**. Yes.

Senator **McCain**. On the subject of mergers in retrospect, particularly since it didn't happen on your watch, would you say that some, or at least one or two, of the most recent mergers that were approved probably should not have been in light of information that we have today as far as their impact on competitiveness?

Mr. **Shane**. I will feel more confident in trying to answer that question after the study is done, because it is precisely that kind of question that is the subject of the study.

Surely if at the end of the day it looks as though we have reduced competition by virtue of those mergers, you would have to reevaluate your reasons for having approved those mergers with the wisdom of hindsight. But we just aren't there. There will not be any reluctance to say, if the evidence demonstrates that it is the case, that we shouldn't have done it. The analysis at the time simply did not support a rejection of those mergers. And I know how controversial that has been.

Senator **McCain**. I will admit that the next issue is a bit philosophical and we are talking about airline acquisitions in particular and not LBOs in general. But in your statement you said, "The Northwest buyout is almost certainly a harbinger of future LBO attempts in the airline industry." I agree. I read the same media reports that you do. United, Delta have been mentioned, possibly others.

The interesting and disturbing aspect of this to me is that healthy airlines that have operated in an efficient fashion, that have very healthy debt-equity ratios, that have compiled large amounts of assets and are healthy operating organizations, are the ones who are the targets. I haven't heard of anybody who has considered taking over Pan Am or TWA or Continental.

So, isn't it disturbing to you that healthy, efficient airlines would be penalized for efficient operations by becoming the target of takeovers, whereas other airlines who have for a variety of reasons assumed large amounts of debts—some of them I understand the ratio is infinity—would not in any way be in danger? The management and people who have made these thriving, strong corporations are now in danger of losing their jobs and their responsibilities because they have succeeded. Does that disturb you?

Mr. **Shane**. Well, there are a couple of assumptions in the question which I guess I would question. First of all, the assumption that an airline company is healthy and efficient by virtue of the fact that it has a lot of equity in its balance sheet as opposed to debt, I think, is not self-evident.

Senator **McCain**. What about if they just have good revenues?

Mr. **Shane**. The question in my mind would be are they doing everything possible to exploit the franchises that they have been given. It is very difficult to talk about particular airlines on the record because the market goes haywire when we do that. But I would make the case to you that there are companies with very healthy balance sheets which are not doing everything they can to maximize the public interest. We have given airlines international routes. They, of course, have a deregulated system now at home. They can fly all over the United States. Are they exploiting the opportunities available to them to the maximum ability, to the maximum extent, and are they providing the most competitive system?

Now, when the financial community spots an airline with a lot of cash and with a lot of equity, with some hidden assets perhaps, and decides to go after it, there can be a variety of motivations there. One motivation would be, of course, to just grab the assets, spin them off, and run away with a lot of money. I think if that were the case, there wouldn't be any question that we would be very concerned about the impact of that phenomenon on the airline industry. It is fair to say that we would be destroying it, although there are economists out there that will tell you that even that won't destroy the airlines because those assets will find a home with management that is interested in using them as efficiently as possible. I do not know if I go along with that analysis, but anyway, that is one sort of motivation.

Another motivation is you have an airline with a lot of equity. It seems to have a lot of opportunity that it is not using. There are good financial reasons and good up-side potentials within the company itself for heads-up management to go in and turn it into something that it is not, a far more aggressive airline and a far more competitive airline.

I have no doubt that if you ask the people who are going after Northwest Airlines right now, they will tell you that that is the situation that they see. That is why they are in this business. They are not trying to take the company and turn it into a variety of assets that can be spun off. They think there is a tremendous amount that can be done with Northwest Airlines to add competition, to add service, and to add quality to the airline industry.

You asked are we, therefore, penalizing the successful company? The question is really, in my mind, whether or not putting new management in is a penalty or is the net result of not doing as much with a company as might otherwise be done. It is a very complicated question. You can't leverage Pan Am or Continental or TWA. There is nothing to leverage. It is pure leverage.

Senator **McCain**. So, whether they are efficient or inefficient, it doesn't make any difference.

Mr. **Shane**. Well, you know, those companies didn't become leveraged because somebody decided to leverage them in order to abscond with the assets. They became leveraged over a period of time as a result of a whole history which I do not have to go into here. So, you wonder whether or not if somebody had come in earlier, leveraged them all at once and tried a different strategy, whether you would, in fact, have more successful airlines, albeit it leveraged, than the ones you have now. It is very difficult to go back and rewrite history, but I do not think it is at all clear that it is a bad phenomenon.

Senator **McCain**. We want to do what we can not to have history repeat itself.

Mr. **Shane**. Absolutely.

Senator **McCain**. If Eastern Airlines continues to be basically dismantled, as it appears it is on that track, is that good or bad for the airline industry in America? Is that good or bad for the consumer in America?

Mr. **Shane**. Well, if Eastern gets rid of some parts of the system that they have not been very successful with, and those parts of the system end up in the hands——

Senator **McCain**. Perhaps parts of the system they have been most successful with like the shuttle.

Mr. **Shane**. Yes. Well, let me finish my part of the answer and then I will take on that one.

The first part of my answer is if they get rid of parts of the system that they have not been very successful with and they shrink the system to the point where they can operate it efficiently and begin to grow from that successful core, then I think that is a good thing. Then I don't see how it can be a bad thing because the parts of the system that aren't operated successfully right now hopefully will be better operated by whoever acquires or takes over those parts of the system.

Yes, there will be cases in which they see an opportunity to get a tremendous amount of cash from selling a successful part of the system, and I think that is right. That is, indeed, the shuttle example. Is it bad that someone else will be running the shuttle now? I don't know why. If the shuttle is going to be as efficient or more efficient by virtue of new management coming in, I'm not clear that there is a negative there for the public interest.

Senator **McCain**. What about the aspect of another major airline, such as American Airlines, taking some of their routes, including the South American routes, providing again a larger concentration of the airline industry in the hands of fewer and fewer airlines?

Mr. **Shane**. There is a lot of speculation about that transaction in fact happening, and you can understand why as a regulator it is very difficult for me to be in the position of trying to prejudge it.

But American is not very big in Latin America right now. The major other competitor——

Senator **McCain**. They are sure big every place else.

Mr. **Shane**. They are a big carrier in the United States. They are not a big international carrier at the moment.

Pan Am and Eastern have been the two big stories in Latin America. If you took Eastern out and you put American in, the question would be, are you enhancing or deteriorating competition. And I think it is not difficult to guess that you might very well be enhancing competition at least in services between the United States and Latin America by the addition of a strong carrier in place of Eastern.

Senator McCain. Just two more questions, Mr. Chairman.

What is the down side to the Secretary of Transportation acquiring the power and authority that is contained in S. 1277 legislation proposed by Senator Ford and myself? What is the down side to it?

Mr. Shane. The only down side would be that if, in fact, LBOs turn out not to be inherently bad for the industry after a deliberate inquiry into that phenomenon, you would have created a regulatory hurdle. It seems to me that the regulatory hurdle would be having to get a Department of Transportation license to consummate a transaction which doesn't exist right now and which might very well affect the robustness, if you like, of the financial market in transactions of that kind.

How big a down side is it? I do not want to be locked into a position of objecting to that because I don't know yet. As I say, I think that for all intents and purposes, our aggressive use of the fitness review authority is virtually tantamount to that authority. So, it may very well be that an objective look at your draft legislation would result in the conclusion that there is no effective difference and therefore, by the same token, there can't be a big down side to it. But we would like to reserve judgment on it.

I would say just a couple of other things if you want to talk for a moment about what is in the draft legislation itself because I do not know what you will do with it. It seems to me that it is worth examining whether a 25-percent threshold makes any sense. You don't have a takeover until somebody has 50 percent to begin with. So, why the number 25 percent?

And second, we have a whole variety of takeovers going on in commuter carriers which nobody would suggest affect the health or dynamism of the U.S. airline industry. And we would want to at least focus on large jet air carriers, the majors, rather than all the commuters that we have that might be technically subject to those kinds of review procedures in the event the language was adopted as presently drafted. So, if there is, in fact, further work on that bill, we would want to work with you.

Senator McCain. Thank you.

Finally, you mentioned governmentally bestowed assets. Do your remarks also include the meaning of slots?

Mr. Shane. Yes.

Senator McCain. Thank you, Mr. Chairman.

Senator Ford. Thank you, Senator McCain.

We have been joined by the distinguished Senator from Alaska, Senator Stevens. Do you have any questions of Secretary Shane?

Senator Stevens. Mr. Chairman, I just dropped in to hear the Secretary, and I'm not sure I quite really understand that last comment. I'm sorry I dropped in now.

What you are really saying, Mr. Secretary, is that you don't mind us thinking about trying to corral the big sharks, but we ought not to worry about the little sharks. I come from a land of little sharks, you know. Ninety-five percent of our people who travel anywhere travel by air, and the majority of those travel on commuters. So, what you are saying is you can have all the LBOs you want in the land of commuters, but you couldn't have them in major cities. Now, why is that?

Mr. **Shane**. Well, no. I was saying that the problem, at least to the extent it has been identified, has been a problem affecting large air carriers, that those are the transactions that I think the subcommittee is most focused on and most worried about. The transactions that we see taking place in the commuter air carrier industry by and large have not been bad and are essentially a mechanism for ensuring that we have healthy commuters. And if we were to identify a negative in transactions affecting them, then I withdraw the remark. I just haven't seen that.

Senator **Stevens**. Wasn't Texas Air a commuter to start with? I know Pan Am was.

Mr. **Shane**. Yes.

Senator **Stevens**. Pan Am started in my state. LBOs and mergers and merger mania start with the small ones, don't they, as they start getting bigger and then they start swallowing other people?

I just seem to think that if we are going to watch sharks, we ought to watch them no matter what size they are. That is my point.

Mr. **Shane**. Well, I do not disagree. I think that to the extent that commuters can get bigger, it is not a bad thing.

Senator **Stevens**. It's not a bad thing, but if the LBOs per se are bad things for large airlines, why aren't they bad for smaller commuters?

Mr. **Shane**. The pools of assets we are talking about in the context of large jet air carriers, the Northwests of the world, are very attractive to the financial community, and we are worried about whether or not the financial community is interested in a healthy large air carrier industry or whether they are interested in those assets. What we have not seen in the commuter category are takeovers which were for the purposes of taking the airplanes and selling them and destroying the carrier. I am just not familiar with a pattern of that kind.

Senator **Stevens**. I would like to see that part of the study, and I do not want to prolong this.

But I have the opinion that we are coming to a threshold now of the subject of what should the Congress do, if anything, about the whole merger mania and LBO mania that exists in the financial world. And my colleagues here have touched it just in one part of the financial community, that that affects airlines. But I do not think, at least from this Senator's point of view, that we ought to rule out the application of the principles of the smaller commuters that have a great deal more to do with the economy of my state than airlines per se have to do with the economy of the Nation. At least I hope you will keep that in mind.

I would reserve judgment on this bill. I think they are going in the right direction. I just wish the whole Congress was looking at the whole financial market as they are this portion of it.

Thank you, Mr. Chairman.

Senator **Ford**. Thank you, Senator Stevens. I think there is a real concern and a movement in light of the foreign investment hearings we held the other day, now the LBO hearing today. I think there is a real concern across the Congress as to what direction we are going. I, as one Senator, am not opposed to free enterprise, buying out, selling and that sort of thing. But it begins to look like countries are investing in our industries, our entities, where we couldn't invest in theirs. Cross currents begin to bother me.

Let me ask you one final question, Mr. Shane. If you develop an investor's intent to dismantle the assets, what would be your judgment on that?

Mr. **Shane**. If there were no question but that the intent of the acquisition was to take the airline apart, we would have to question whether or not that was in the interest of maintaining a fit airline. I would personally advocate taking steps to prevent an acquisition for the purposes of taking an airline apart, but that would really depend on what the airline was doing in the first place and whether or not taking the airline apart was, in fact, a bad thing for the industry overall. A difficult question to answer in the abstract I guess is what I'm saying. We are not dealing with that, as I understand it, at the moment.

Senator **Ford**. The introduction of the legislation had some intent to it. But before we try to get to a final markup of this bill, I think it's important that we address the question of whether that should be a part of our legislation. So, we are moving and we will have other hearings. This will not be the last one before this bill sees daylight. So, I would like to get all the facts in the hearings to try to determine what is the right direction and what is the right policy for us to set and for you to carry out.

Mr. **Shane**. One of the things that I would say about a transaction in which there was an intended dismantling of an airline is that that transaction will be a transaction which was designed to put the airline out of business, as you have set out the question. And if in fact somebody wants to buy an airline in order to put it out of business, I do not know what a government can do under any law to prevent that transaction from happening. Our responsibility ought to be to make sure that the airlines that are in business are fit, willing and able to provide that service within the meaning of the Federal Aviation Act and all of the law that surrounds it at this point.

But if somebody just wants to buy the airline and sell the airplanes and there is no more airline, I do not know that government really has a responsibility to say, no, you can't do that. We have to assume that those airplanes are going to end up flying someplace. And it may very well be that somebody is going to create a new airline out of those assets.

Senator **Ford**. And a member of the investment group could be one of those airlines that was going to acquire a portion of the assets. There are lots of things going on.

Do you have any questions, John?

Senator **McCain**. No.

Senator **Ford**. Thank you, Mr. Secretary. We appreciate your coming this morning and look forward to working with you and hope you will send your papers around to the staff here on the

Aviation Subcommittee that you send around to other departments.

Mr. **Shane**. Thank you, Mr. Chairman.

Senator **Ford**. Thank you, Mr. Secretary.

We are now pleased to have the distinguished Attorney General of the State of Minnesota, the Honorable Hubert H. Humphrey III. He is here on behalf of the National Association of Attorneys General to testify. And he is accompanied by Alan Gilbert I believe. Isn't that right, Skip?

Mr. **Humphrey**. That is correct, Mr. Chairman.

Senator **Ford**. We are delighted to have you here this morning and appreciate you coming and representing the association. So, you may proceed. If you want to highlight your statement, that will be fine. Your total statement will be included in the record.

Mr. **Humphrey**. Thank you, Mr. Chairman, and I would hope that that would also include the resolution of the National Association of Attorneys General.

Senator **Ford**. The resolution will be included in the record by reference.

STATEMENT OF HUBERT H. HUMPHREY III, ATTORNEY GENERAL, STATE OF MINNESOTA, ACCOMPANIED BY ALAN GILBERT

Mr. **Humphrey**. Thank you, Mr. Chairman, Senator McCain. I appreciate the opportunity to testify before this subcommittee on the vital subject of airline takeovers. I offer my perspective as the Attorney General for the State of Minnesota and in addition, I want to convey to you the position of the National Association of Attorneys General.

Both the association and I support Federal legislation requiring prior review and approval of airline takeovers by the Secretary of Transportation. The association's position is reflected in its resolution of July 12, 1989, which has been placed in the record at this hearing. And I would like to briefly elaborate on the basis for my support of this legislation.

The development of this country's air transportation system has been a joint effort, a real partnership between private business and the public. Private enterprise has committed substantial resources to provide the necessary aircraft, equipment and personnel to operate a successful airline. The public contributes to this joint venture in at least two vitally important respects.

First, enormous amounts of public funds, Federal, state and local, have been invested in the planning and construction of airport facilities and the provision of air traffic control systems.

Second, the public has to a significant extent located its businesses and homes in areas that are serviced by accessible air transportation service. The resulting large and centralized public market for air transportation services has greatly enhanced the economic viability of the airline industry.

This industry, however, can be instantly jeopardized by a highly leveraged takeover of a major airline, and a highly leveraged bust-up takeover would severely impact the other partner in our air transportation, the public. The dramatic impact of an airline takeover is aptly demonstrated I believe by the Northwest Airlines situation.

Mr. Chairman, in March a takeover battle was launched with the announcement by Marvin Davis that he was making a $90 per share tender offer for all of the outstanding shares of Northwest Airlines, Inc., the parent corporation of Northwest. The financing package for the transaction included $3 billion in debt and only $300 million in equity, a 10 to 1 debt to equity ratio.

Securities analysts were virtually unanimous in the view that this highly leveraged takeover of Northwest Airlines would require a sell-off of at least some major assets, and would require curtailment of the company's plans for modernizing its fleet.

The Davis proposal was met with great public concern. Although the takeover could certainly impact the traditional corporate constituencies, shareholders, creditors and suppliers, the proposal presented uncertainties that affected the public different from other kinds of takeovers. It potentially affected airplane safety, fleet modernization, environmental considerations, industry competition, airflight availability and accessibility, the service component, and the public's enormous investment in airport facilities. Takeovers in other industries just don't affect the public in the same unique and critically important ways as takeovers in this industry.

After the Davis offer, another proposal was made to acquire Northwest. The recently proposed takeover offer does not appear to carry as high a debt to equity ratio as the first proposal, but it should be thoroughly examined to ensure that the public interests are not adversely affected.

Now, let me just outline the important public interests in these areas, Mr. Chairman.

First, the financial condition of an airline directly affects public safety. Airplanes are incredibly expensive. A highly leveraged takeover that imposes large annual interest payments on an airline can impair its ability to replace old planes. To ensure public safety, it is crucial that airlines have the financial wherewithal to modernize their fleets.

And airline safety can also be compromised by the takeover's impact on airline employees, a major stakeholder in our air transportation system. Clearly the dedicated service, knowledge and specialized expertise of airline personnel is a critical component in the success of the airline industry. The safe operation and maintenance of aircraft depends on competent, conscientious airline employees. A takeover that financially cripples an airline will ultimately reduce employee complements, adversely affect employee morale and limit resources available to allow airline employees to properly perform their jobs. This could well jeopardize the safety of air transportation. The essential contribution airline employees make to our air transportation system must be a significant consideration in assessing the impact of an airline takeover.

Next, to the extent that highly leveraged takeovers delay fleet modernization, they delay replacement of old and noisy stage two aircraft with new and quieter stage three aircraft. This is an important environmental concern. Airport neighborhoods have long suffered from the noise pollution under flight corridors. Like many other communities, we in Minnesota are depending on the advent of the acquisition and operation of newer and quieter stage three aircraft for much needed relief from this kind of noise pollution.

Third, a highly leveraged takeover of an airline could easily result in dramatic changes in flight availability and accessibility. Even though the demand for air transportation services has not lessened, aircraft, international routes and gates may be sold off to pay debt. Alternatively, the resulting airline could be financially unable to operate the flights previously flown by its predecessor. The public, which has come to depend upon, and in fact is a true partner in helping develop, the air transportation system in that particular region, may be suddenly faced with severely restricted air transportation schedules. Major changes in air transportation can quickly impact local, state, regional and even national economies.

Next, the public's financial investment in our airport facilities is also at risk when an airline is subject to a takeover. Federal, state and local monies have allowed the construction and maintenance of huge billion dollar airport facilities. A highly leveraged takeover that jeopardizes the financial capability of a major airport tenant could well undermine the financial viability of public airport facilities.

And finally, Mr. Chairman, competition will not necessarily fill the void. In a capital intensive business like airlines, it is not at all clear that other airlines would enter the market to the same extent as the prior airline. In any case, it could take substantial time for a new airline, or even an existing one, to develop a meaningful presence in the affected region.

Air transportation is already a concentrated industry. Eight major air carriers reportedly control 93 percent of the domestic market. The loss or a financial crippling of just one of these airlines means further increased concentration and reduced competition.

Now, I am pleased to see that Secretary Skinner has announced he will scrutinize Northwest's takeover. But in view of the prior administration's reluctance to involve itself in the broader based impact of airline takeovers, it is critical that Congress impose an express, affirmative obligation on the Secretary of Transportation to review airline takeovers.

What is at stake here is the health and survival of the domestic airline industry. Airlines that are highly leveraged in good economic times will find themselves in bankruptcy in tough economic times. This country does not need and cannot absorb more airline bankruptcies.

I support the bill under consideration by this subcommittee. This legislation will require the Secretary of Transportation to consider safety, fleet modernization and ability to satisfy obligations to airport facilities before approving an airline takeover.

But I urge you to expand the bill to require the Secretary of Transportation to consider other important public interests in assessing airline company takeovers. The additional factors that I believe should be included are these: the ability of the airline, after the takeover, to maintain the availability and accessibility of air transportation services; the impact of the takeover on airport facilities generally; the impact of the takeover on the communities serviced by the airline; and the impact of the takeover on the airline's employees.

Only by applying these criteria can the Secretary of Transportation adequately address the important and legitimate public concerns raised by an airline takeover. These criteria recognize the true partnership interest of the public in the successful development of our air transportation system.

Thank you again, Mr. Chairman, for the opportunity to appear before you and express my views and those of the National Association of Attorneys General on this important issue.

[The statement follows:]

TESTIMONY OF HUBERT H. HUMPHREY, III
MINNESOTA ATTORNEY GENERAL

BEFORE THE AVIATION SUBCOMMITTEE OF THE
SENATE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION

JULY 14, 1989

I appreciate the opportunity to testify before this subcommittee on the vital subject of airline takeovers. I offer my perspective as the Attorney General for the State of Minnesota and, in addition, am conveying to you the position of the National Association of Attorneys General.

Both the Association and I support federal legislation which requires review and approval by the Secretary of Transportation prior to the consummation of the takeover of an airline. The Association's position is reflected in the attached resolution which was adopted on July 12, 1989. The basis for my position is set forth in this testimony.

Over the course of the last five years my office has been involved in several lawsuits challenging state corporate takeover laws. We have also considered and drafted amendments to existing state takeover legislation. During that time, takeovers and the techniques and strategies used in attempting and defending takeovers have evolved quickly producing substantial changes in corporate America.

As the takeover landscape has changed and the impact of these transactions have been felt on our economy and the American people, great debate has been waged regarding the propriety and possible forms of takeover regulation. Although the regulation of takeovers generally presents some difficult public policy questions, I believe that takeovers in certain key industries clearly require scrutiny by government to protect unique and critically important public interests. Our recent experience in Minnesota with the proposed takeover of Northwest Airlines, as well as the threatened takeover of the Chicago and Northwestern Railroad, has persuaded me that the public interests in safe, efficient, environmentally sound, accessible and competitive air and rail transportation require federal review of takeovers in these industries.

As you know, legislation pending in Congress would require Interstate Commerce Commission approval of the takeover of Class I railroads. Today, I address my remarks to the need for similar scrutiny over airline takeovers by the Department of Transportation.

The development of this country's air transportation system has been a joint effort between private business and the public. Private enterprise has committed substantial resources to provide the necessary aircraft, equipment and personnel to operate a successful airline. The public contributes to this joint venture in at least two vitally important respects. First, enormous amounts of public funds including federal, state and local monies, have been invested in the planning and construction of airport facilities. Second, the public has, to a significant extent, located its businesses and homes in areas that are serviced by accessible air transportation service. The resulting large and centralized public market for air transportation services has greatly enhanced the economic viability of the airline industry.

This partnership between private business and the public has allowed our air transportation system to flourish. While improvement in air transportation services is still necessary, throughout much of this great country air travel is readily available at affordable prices; the industry's overall safety record is good; and commitments have been made to modernize existing fleets. A takeover, though, of a major airline, especially a highly-leveraged, bust-up takeover, can instantly jeopardize the accomplishments of the airline industry and adversely impact the other partner in our air transportation system, the public. The dramatic impact of an airline takeover is aptly demonstrated by the Northwest Airlines situation.

Speculation began earlier this year that Northwest Airlines was about to become a takeover target. In March a takeover battle was launched with the announcement by Marvin Davis that he was making a $90 per share tender offer for all the outstanding shares of NWA, Inc., the parent corporation of Northwest Airlines. The financing package for the transaction involved a total of $3 billion in debt and only $300 million in equity; in other words, a 10 to 1 debt to equity ratio.

According to securities analysts, the cash flow of Northwest Airlines appeared inadequate to cover both the several hundred million dollars annual debt load and at the same time provide the funds necessary to continue Northwest Airlines' ambitious and essential program of fleet modernization. The analysts were virtually unanimous in the view that this highly leveraged takeover of Northwest Airlines would require a selloff of at least some of its assets, and would require curtailment of the company's plans for modernizing its fleet. These industry experts further indicated that a debt burdened Northwest Airlines would not be able to withstand an economic downturn and that the takeover could lead eventually to the bust up of the company. According to many, a dismantling of Northwest Airlines seemed likely since the company's real estate, international routes, gates and planes were worth more in their individual parts than was Northwest Airlines as an operating company.

The Davis takeover proposal was met with great public concern. Although the takeover could certainly impact the traditional corporate constituencies, such as shareholders, creditors and suppliers, the proposal presented additional uncertainties that affected us differently from other takeovers. It potentially affected airplane safety, fleet modernization, environmental considerations, industry competition, air transportation availability and accessibility and the public's huge investment in airport facilities.

Subsequent to the Davis offer, another proposal was made to acquire Northwest Airlines. Although the recently proposed takeover does not appear to carry as high a debt to equity ratio as the prior proposal, it nevertheless should be thoroughly examined to ensure that the public interests are not adversely affected.

It is beyond question that the financial condition of an airline directly affects passenger safety. Airplanes are incredibly expensive. For example, Northwest Airline's pre-takeover plans called for the purchase of $7.4 billion of new planes over the next several years. A highly leveraged takeover that imposes large annual interest payments on an airline can impair its ability to replace old planes. Recent events show that the safety risk associated with aging planes is very real. There have been three major accidents involving old airplanes losing critical parts of their structures while in flight. Two of these tragic accidents resulted in death to passengers. To ensure passenger safety, it is crucial that airlines have the financial wherewithall to modernize their fleets.

Airline safety can also be compromised by a takeover's impact on airline employees, a major stakeholder in our air transportation system. Clearly, the dedicated service, knowledge and specialized expertise of airline personnel is a critical component in the success of the airline industry. The safe operation and maintenance of aircraft depends on competent and conscientious airline employees. A takeover that financially cripples an airline will ultimately reduce employee complements, adversely affect employee morale, and limit resources available to allow airline employees to properly perform their jobs. This, in turn, could well jeopardize the safety of air transportation. The essential contribution made and continued to be provided by airline employees to our air transportation system must be of significant consideration in assessing the impact of an airline takeover.

Furthermore, to the extent that highly leveraged takeovers delay fleet modernization, they delay replacement of old and noisy Stage Two aircraft with new and quieter Stage Three aircraft. This is an important environmental concern. Airport neighborhoods have long suffered from the noise pollution under flight corridors. Like many other communities, we in Minnesota are depending on the advent of the newer and quieter Stage Three aircraft for much needed relief from this noise pollution.

In addition, a highly leveraged takeover of an airline could easily result in dramatic changes in flight availability and accessibility. Even though the demand for air transportation services has not lessened, aircraft, international routes and gates may be sold to pay off debt. Alternatively, the recomprised airline could be financially unable to operate the flights previously flown by its predecessor. The public, which has come to depend upon, and in fact as a true partner helped develop, the air transportation system in that particular region, may suddenly be faced with severely restricted air transportation schedules. Major changes in air transportation can quickly impact local, state, regional and ever national economies.

The public's financial investment in our airport facilities is also at risk when an airline is the subject of a takeover. Federal, state and local monies have allowed for the construction and maintenance of huge billion dollar airport facilities. A highly leveraged takeover that jeopardizes the financial capability of a major airport tenant could well undermine the financial viability of public airport facilities.

Competition will not necessarily fill the void. In a capital intensive business like the airline industry, it is not at all clear that other airlines would enter the market to the same extent as the prior airline. In any event, it could take substantial time for a new airline, or even an existing one, to develop a meaningful presence in a particular region.

Moreover, a takeover of a major airline could actually lead to less competition. In an already concentrated industry where eight major air carriers reportedly control 93% of the domestic market, the loss or the financial crippling of just one of these airlines would mean further increased concentration and reduced competition. A free market system is effective and efficient as an allocator of resources only if there is true competition.

Unfortunately, the Department of Transportation, at least prior to Secretary Skinner's administration, has had little interest in many of the real and critically important impacts of airline takeovers. As recently as January 23, 1989, in an order involving a continuing fitness investigation into Carl Icahn's management of Trans World Airlines, the Department of Transportation reiterated its previously expressed view that it did not intend "to be drawn into takeover attempts or other management disputes as a matter of course or to otherwise substitute unnecessary government regulation for the competitive pressures of the marketplace."

This is a shortsighted position. I am gratified to see that Secretary Skinner has announced he will scrutinize the Northwest Airline's takeover. However, in view of the prior administration's reluctance to involve itself in the broader based impacts of airline takeovers, it is critical that Congress impose the responsibility for reviewing airline takeovers on the Secretary of Transportation as an express affirmative obligation.

What is at stake here is the health and survival of the domestic airline industry. Airlines that are highly leveraged in good economic times will find themselves in bankruptcy in tough economic times. This country does not need and cannot absorb more airline bankruptcies. Unless we impose some kind of public interest review of these takeovers that is exactly what could happen during the next recession. And at that point, Congress may be faced with the prospect of spending billions of dollars to bail out another industry---airlines.

I support the bill under consideration by this subcommittee. This legislation will require the Secretary of Transportation to consider safety, fleet modernization, and ability to satisfy obligations to airport facilities, before approving an airline takeover. I urge you to expand the bill to require the Secretary of Transportation to consider other important public interests in assessing airline company takeovers. The additional factors should include:

1. The ability of the airline, after the takeover, to maintain the availability and accessibility of air transportation services;
2. The impact of the takeover on airport facilities generally;
3. The impact of the takeover on the communities serviced by the airline; and
4. The impact of the takeover on the airline's employees.

Only by applying these criteria can the Secretary of Transportation adequately address the important and legitimate public concerns raised by a takeover of an airline. These criteria recognize the true partnership interest of the public in the successful development of our air transportation system.

Thank you again for the opportunity to appear before you and express my views and those of the National Association of Attorneys General on this important public issue.

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Senator FORD. Thank you, General. I have two or three questions I would like to ask.

You have stated that you do believe that competition will not fill the void created by the demise of a highly leveraged airline. What are your reasons for making that statement, and what effect do you think it will have on air travelers?

Mr. HUMPHREY. Well, Mr. Chairman, as I mentioned in my opening remarks, the key here is the way in which the industry is structured. It is a highly capitalized industry. It is an expensive operation to get into. There isn't that ease of access of coming into the industry. That is one of the problems with regard to the concentration.

There is also, as I mentioned, the timing. Even if someone has the ability to provide the same service or even expanded service beyond that of the predecessor airline, it takes time to develop that level of service. In the meantime, there is a real concern of concentration.

In fact, I find it rather interesting to note that prior to deregulation and the deregulation act, there were eight major airlines. Subsequent to the deregulation act, after everybody got over and done with all of whatever was being done, there are still just eight major airlines. And there is a higher level of concentration. Ninety-three percent of the routing and the movement of people are done by those airlines.

Senator **Ford**. General, many in the airline industry view any attempt to impose Federal restrictions as a form of reregulation. Do you see the legislation which you apparently endorse today with suggestions of some additions as reregulation?

Mr. **Humphrey**. No, I do not, Mr. Chairman. First of all, under the present authority, there is regulation, as I believe the Assistant Secretary mentioned.

But in addition, the pending legislation with my recommendations really is aimed at the common goal that the deregulation statute was all about, and that is to see that there is effective competition and a safe airline industry. So, in fact, it is reaching towards the same goal to see that we have a competitive airline industry.

Senator **Ford**. Of course, your are right there under the gun in Minnesota where a major Northwest hub is located. Do you have any interest in seeing that the provisions of S. 1277 apply to cover that transaction?

Mr. **Humphrey**. Well, Mr. Chairman, I would hope that whenever the legislation is adopted that it would take into account all pending transactions at that time. I do not think there needs to be a delay. Obviously, the current transaction is under some scrutiny by the Department of Transportation. I do not believe you have to go backwards in this business, but I think what you are trying to do, and what I understand that legislation to do, is to clarify and make express the wishes of Congress rather than leaving it to the discretion of a given administration or a given Secretary.

Senator **Ford**. General, in your curbstone opinion here—maybe you have already reviewed it—would a retroactive application be upheld in the courts?

Mr. **Humphrey**. Mr. Chairman, I have not specifically reviewed that. I guess my concern is to see that we go forward immediately from where we are. I just can't give you a direct opinion on that at this point. I think you could probably make a pretty good argument, though.

Senator **Ford**. I had a lawyer tell me one time, tell me which way you want me to go and we'll make a good case.

The resolution that was adopted by the association addressed both airlines and railroads. While this is an Aviation Subcommittee hearing this morning, would you outline the similarities between the two industries with respect to the issue of LBOs?

Mr. **Humphrey**. Yes, sir. I guess I can do it best by example. Japonica has attempted to takeover the C&NW, Central and Northwestern Railroad. I believe there is something like a $165 million equity offer, and a $610 million debt structure that was being offered for the takeover.

The ICC has jurisdiction under this circumstance and has indicated by letter that it is not certain whether it has the authority to veto these kinds of highly leveraged takeovers. The ICC has also raised the concern that with this kind of highly leveraged buyout, a railroad may not have the ability to maintain the service in the rural areas or to maintain the necessary quality of the roadbeds. The concerns are essentially the same for airlines and railroads safety, service, the ability to maintain public facilities and the provision of service to the public as a whole and to the business community as a whole.

Senator **Ford**. Did I understand you to say that the ICC had written that it was doubtful that they had any jurisdiction of the LBO of the line?

Mr. **Humphrey**. Mr. Chairman, I would have to give you the specific letter, but I believe it was limited to the question of whether it could veto the pending takeover. I don't believe the ICC questioned whether it had some jurisdiction to review, to look at, the ongoing ability of the company to provide the services, but to literally say, no, this is not the kind of thing that is going to maintain the public interest concerns over which it has responsibility.

Senator **Ford**. You may have heard Mr. Shane when he said earlier under the present situation they can place a harsh liability on the air carrier by pulling their certificate. But he says he thought just the idea that the Department of Transportation said it wasn't a good deal, would make everybody would back out. I am not sure that is really what is going to happen because there may be some other motives underneath that as we might suspect.

Would the ICC have the same ability to say they didn't think it was good, but they couldn't veto the transaction?

Mr. **Humphrey**. Well, Mr. Chairman, I think that is why the point was raised in the letter by the ICC that questioned whether they had that ability to veto the takeover. And, Mr. Chairman, I think that just raises the example of why it is important that Congress expressly state what needs to be reviewed and to impose a requirement of prior review.

Senator **Ford**. I believe Senator Exon has introduced a bill similar to ours for railroads, and possibly, after we have our hearings, we could merge the two. And as you say, you drew the parallel and the concerns of safety and service and that sort of thing. So, we are, as Senator Stevens said earlier, just nibbling at it, but there is a whole big pot of problems there, and maybe we at some point can bring it all together.

Senator McCain.

Senator **McCain**. Thank you, Mr. Chairman.

Thank you for being here. It is nice to see you again, Mr. Attorney General.

Mr. **Humphrey**. Thank you, Senator.

Senator **McCain**. I think you make a very strong case. Obviously, it is an important opinion, not only credibility, but that of the association which you have so ably represented.

Let me speak philosophically with you just for a minute. Some say that the threat of an LBO is needed in order to ensure that existing management maximizes its resources and operates in a most efficient fashion. In other words, if there is never any danger of their management being threatened, they can indulge in various excesses and not focus all their attention on the efficiency of the airline. Now, in TWA people are making a case that the airline is being run much more efficiently now that it has been taken over. There are some who would argue that Northwest in your own state has had severe labor-management problems that may have been able to be addressed by more efficient management.

How do you respond to that argument?

Mr. **Humphrey**. Well, Mr. Chairman, maybe I can just state in my own particular bailiwick of Minnesota, but I dare say that the labor-management problems that have existed with Northwest are a result of the merger between Republic and Northwest. They are now being resolved. Certainly you did not have those problems before because you had two competing airlines. In fact, it was pretty good. We had great service back and forth between Washington and Minnesota.

Senator **McCain**. But also didn't they have several severe strikes long before airline deregulation came into being?

Mr. **Humphrey**. Yes, Mr. Chairman, that is correct. In fact, obviously, in the newspapers today there is some concern that there may yet be another strike.

I would just say, Senator, that you raise a valid point. There should be an opportunity for that hammer to be out there in the marketplace to say you better be operating efficiently or someone else is going to come in and operate more efficiently.

I do not believe that the draft legislation you are considering nor the suggestions that I have offered here in addition would impair that opportunity at all to allow that kind of transaction. The key here is to absolutely make certain in this very important industry that the public interests are considered. There are very significant, substantially different public interests here as I think you so eloquently stated—and if you don't mind, I'm going to use it out in Minnesota at some point—airplanes are not corn flakes.

Senator **Ford**. Give him credit for it.

Senator **McCain**. Please feel free to steal it. I do it all the time.

Mr. **Humphrey**. But airplanes are not corn flakes. And, Mr. Chairman, that is exactly the circumstance that I think we find ourselves in. I do not believe that the legislation you are talking about impairs that kind of tension that ought to be there in the marketplace. But I do not believe we should stand aside and say because there are these philosophical views about takeovers and the marketplace operation, that we should step back from the responsibilities of providing safe and broad-based public service in a vital transportation industry.

Senator **McCain**. I have no more questions.

I would like to take this opportunity to again thank Attorney General Humphrey for his efforts on behalf of Native Americans in his state on which I have worked with him on several occasions. And I am very grateful for those efforts as well as many other things he has done.

Thank you, Mr. Chairman.

Senator **Ford**. Take it where you can get it, Skip.

Thank you very much.

Mr. **Humphrey**. Thank you, Mr. Chairman.

Senator **Ford**. It's a delight to have you here and we look forward to corresponding with you as it relates to the final package that we develop.

Mr. **Humphrey**. Yes, sir. Thank you. We would be happy to be of assistance.

Senator **Ford**. Thank you for your cooperation.

We now have a panel of two witnesses: Paul Scura, Managing Director of Prudential-Bache Capital Funding—he will be accompanied by Russell J. Greenberg—Mr. Philip Baggaley, Vice President, Standard & Poor's Corporation of New York. If you two gentlemen will come forward, we look forward to your testimony.

Paul, did I get close to pronouncing your name right?

Mr. **Scura**. That's correct, Senator.

Senator **Ford**. You may proceed however you want to. Your total statement will be included in the record as if given. If you want to highlight it, that will be fine.

Mr. **Scura**. I think I will just summarize it.

Senator **Ford**. That will be mighty fine. If you want to proceed.

STATEMENT OF PAUL SCURA, MANAGING DIRECTOR, PRUDENTIAL-BACHE CAPITAL FUNDING, ACCOMPANIED BY RUSSELL J. GREENBERG, DIRECTOR

Mr. **Scura**. Well, first of all, Mr. Chairman and Senator McCain, my colleagues and I welcome and appreciate the opportunity to address the committee to discuss the current state of the airline industry as it relates to leveraged buyouts and the concerns over the changes in ownership of the U.S. airline industry.

My name is Paul Scura. I am a managing director at Prudential-Bache Capital Funding, and I am responsible for the firm's business with financial institutions. Prior to joining the firm in 1986, I was with J.P. Morgan for 11 years and had specific responsibility for the transportation group there.

With me today is Russell Greenberg who is a director in our Mergers and Acquisitions Department. Russell has been with Prudential-Bache since 1986 and has been in the securities industry for nine years.

First of all, I think it is important for the committee to note that Prudential-Bache was advisor to Pan Am Corporation in its attempt to acquire NWA Corp., the parent company for Northwest Airlines. In that regard, Prudential-Bache structured the proposal and arranged approximately $4 billion in debt and equity securities. We ourselves, through our own merchant banking subsidiary, committed to invest $200 million in the proposed acquisition of Northwest Airlines. Our bid was unsuccessful.

We are here today not at the behest of Pan Am, and the views expressed are not necessarily those of Pan Am or the Prudential Insurance Company of America, which is our parent.

Now I would like to turn to the leveraged buyout market as it pertains to the airline industry, with some initial comments about the LBO market in general. LBO's, whether for an airline or an industrial company, require careful consideration and must meet certain standards which satisfy the criteria of all the firms and organizations that participate purely as financial investors, such as insurance companies, commerical banks, or pension funds. These investors, regardless of where they invest within the capital structure, require that the transaction be structured with adequate levels of equity, mezzanine financing, and bank financing to insure that the company is able to meet its obligations to the debt holders and provide the equity investors with the potential to receive their targeted returns, provided that specific levels of operating performance are achieved. A key aspect of an LBO analysis is the determination of the proper rates of return required of each investor. Banks generally require the lowest return since they are often secured and hold a senior position relative to other investors. Equity and mezzanine investors expect much higher returns which, in addition to interest or dividend income, are generated through equity appreciation.

Inherently, certain companies are better LBO candidates than others. The ideal candidate would be a company in a non-cyclical industry, with a stable and predictable cash flow, which also has elements of revitalization—in other words a company whose performance can be enhanced or improved through new management efforts.

Contrast this with that of a typical U.S. airline. The airline industry has historically been highly cyclical and one that requires significant capital expenditures not only to expand, but also to maintain the status quo. The mind set of investors historically has been that leveraged airlines are weaker and cannot expand or maintain a competitive level of service relative to other airlines, particularly in economic downturns.

With this in mind then, why should the financial community focus turn to LBO's in the airline industry? And I think the reasons appear to be simple. As the industry has evolved and changed following deregulation 10 years ago, investors had not properly evaluated the implication of these changes until very recently. The first significant change is that cash flow within the airline industry is more predictable. With the increased use of computers and the advent of advanced computer programs integrated with established revenue and reservation systems, airlines are able to employ sophisticated yield management systems as a way of maximizing seat utilization and pricing.

Another event contributing to the stability of cash flow has been the evolution of the hub and spoke system which most major airlines now employ. This has allowed airlines to manage traffic flow on a connecting basis very effectively. Also the hub and spoke system tends to put an airline in a particularly strong position in a hub city. The hub airlines tend to dominate certain cities with the attached benefits of having developed a major market share. This dominance serves as a significant barrier to entry and serves to insulate cash flows from competitive threat.

The second change that has occurred is the ability of airlines to finance new and used aircraft at attractive terms regardless of how leveraged the airline is. Lenders have increased their sophistication as to the collateral value of aircraft, and that has resulted in their willingness to make loans which equal 80, 90 or even 100 percent of the market value of airplanes. In addition, aircraft leasing companies whose role in the industry has increased dramatically, will lease new aircraft to virtually any airline. A significant portion of the delivery positions for the next several years of the major aircraft manufacturers has been acquired by these operating lease companies. Lessors are less concerned with the credit quality of the lessee because aircraft have been able to hold or increase their value. The net effect is that airlines have creative, cost effective means of raising capital on or off their balance sheet, alternate to either debt or equity to fund the purchase of new and used aircraft.

It is now clear that airlines have the ability to fund much greater levels of debt without restricting their ability to reequip their fleets or expand in to new markets. Even though airlines such as American, Delta, Northwest and United have increased both the size of their markets and upgraded their fleets over the past several years, each of those airlines have conducted common stock repurchases over the same period. The last airline in this group to issue equity to fund expansion was American in 1985.

So, an important point central to the airline industry is that it is now driven by more capacity constraint than by pure price competition. The dramatic increase in new plane orders is not only a reflection of airlines replacing aging aircraft, but the need to increase their own capacity to meet demand created through their hub and spoke systems.

Turning to my final topic, I would like to talk about the foreign airline issue. An important part of any LBO analysis is the determination of the required rate of return for each investor. Typically there are three investor groups in a typical LBO. These include the senior lenders, which are most usually banks; mezzanine investors, which are usually junk bond buyers; and then the equity investors.

The amount of equity contributed relative to the debt used to fund an LBO is perhaps the most vital issue in any transaction. Investors at this level in the capital structure demand a much higher rate of return on their investment than do debt holders due to their greater principal risk. Traditionally investors at this level are involved for the opportunity to earn very high financial returns. They are not strategic investors, but rather passive institutional investors.

In our opinion mezzanine investors in any LBO require rates of return in the range of 20 to 30 percent, while equity investors, those bottom investors, require even higher rates of return ranging from 30 to 50 percent.

Recently there have been a number of investments by foreign carriers in U.S. airlines. The KLM investment in Wings is the most notable example to date.

In terms of an airline LBO, for a foreign airline to accept a lower cash-on-cash equity return, significant economic benefits would be required to be derived through marketing, operating and/or maintenance agreements. Furthermore, an operating agreement between two flag carriers is potentially anticompetitive as it serves to circumvent the bilateral agreements already established between the U.S. and the foreign carrier's home country. An operating agreement is a powerful influence rivaling the impact of the hub and spoke concept to access an airline market. The North American airline market can be readily accessed and perhaps even controlled to a certain extent through international agreements. The tendency for foreign airlines to be wholly or partially government-owned raises the anticompetitive specter to an even higher level.

Last, an LBO with its high degree of leverage and low level of equity tends to allocate real control among the equity and mezzanine holders in proportion to their investment since any modification of the agreement will require the cooperation of all of the significant mezzanine and equity participants. Whether stated or not, this control is real and cannot be ignored.

In closing, I would like to reiterate that an LBO in the airline industry does not differ significantly from that of any other industry. For it to succeed, proper analysis and due diligence must be carefully completed and financing properly structured.

However, given public policy as it relates to foreign control of domestic carriers, a warning bell should sound if foreign carriers provide significant equity in the U.S. LBO, particularly if such equity is provided at such rates of return far below that required by arm's length, passive institutional investors.

This concludes my prepared remarks. Again, we appreciate the opportunity to discuss these important issues with you.

Senator **Ford**. Thank you, Mr. Scura.

Mr. Baggaley, you may proceed.

STATEMENT OF PHILIP BAGGALEY, VICE PRESIDENT, STANDARD & POOR'S CORP.

Mr. **Baggaley**. Mr. Chairman and members of the subcommittee, thank you for the opportunity to appear today.

My name is Philip Baggaley. I am a vice president at Standard & Poor's Corporation, a debt rating agency. My responsibilities include judging the creditworthiness of airlines and transportation equipment leasing companies. Today I would like to offer some thoughts on the effect of leveraged buyouts on the U.S. airline industry.

The past decade has seen a surge in leveraged buyouts, leveraged acquisitions, and recapitalizations of American corporations. So far, the airline industry, with a few notable exceptions, has not participated in that trend. However, we now have the likelihood of one LBO, NWA Inc., and the clear possibility of further transactions if the Northwest acquisition is completed. Investors, Wall Street stock analysts, and nervous executives are already calculating what price the other major airlines could bring and how much debt they could support.

If LBO's do spread through the airline industry, the result will be greater risk of bankruptcy, further consolidation and, quite possibly, slower progress on expanding and modernizing the industry's aircraft fleet. Given the role which airlines play in our national transportation system and in the economy as a whole, that would affect not only shareholders and creditors, but employees and the entire traveling public.

LBO's can be an appropriate financial strategy for certain companies in certain situations. Standard & Poor's has nothing against LBO's or the speculative grade debt, so-called junk bonds, often used to finance them. However, some industries are more suitable candidates than others. An airline LBO is, in my opinion, a risky proposition. The reasons for this can be seen by considering some of the arguments often advanced in favor of LBO's.

It is suggested that companies in stable, recession-proof industries can safely support large amounts of debt. That is true, but airlines are hardly stable or recession-proof. Their earnings and cash flow vary widely with the economic cycle, and they can be vulnerable to strikes, fare wars and terrorism. The 1980's have seen the bankruptcy of three large airlines, Braniff, Continental and Eastern. Another company, People Express, was on the verge of a similar fate when it was acquired. It is true that the industry is becoming more stable as it consolidates and improves pricing techniques, but Standard & Poor's believes that airlines continue to have greater than average credit risk.

The proponents of LBO's argue also that a mature company which is generating more cash than it can profitably reinvest or which has a very strong balance sheet should return some of its equity to the shareholders. Again, this may well be true, and again it does not apply to airlines. Airlines are growing companies with a voracious appetite for capital. The total cost of aircraft on order or option by U.S. airlines approaches $100 billion. Total operating cash flow in the industry last year, a very profitable year, was less than $5 billion. Clearly the industry will have to finance most of its deliveries using debt or leases.

As for strong balance sheets, there is more here than meets the eye. For example, NWA's debt as a percentage of total capital, that is, debt plus equity, was 36 percent as of March 31, about average for an American non-financial corporation. However, NWA also finances some of its aircraft using long-term off balance sheet leases. These are debt in everything but name, and Standard & Poor's considers them as such in our internal deliberations.

In the case of NWA, the debt equivalent of aircraft operating leases is over $1 billion compared to only $945 million of balance sheet debt. Debt including leases as a percentage of capital is about 55 percent. And there are more dramatic examples than NWA, which uses fewer leases than most airlines. Delta's debt to capital rises from 23 percent, a conservative figure, to 60 percent when you include leases.

A third argument often advanced in support of LBO's is that they can remove inadequate management and improve operating performance. This might have applied to airlines several years ago when Carl Icahn took over TWA and United's shareholders ousted management, but it is less relevant today. The companies being targeted as potential LBO candidates, such as American, Delta, United and USAir, are well-managed, profitable enterprises. In fact, it is their very success which makes them vulnerable. If their earnings and cash flow can support more debt, why not load it on?

What all of these means is greater risk of bankruptcy. How much greater no one can predict precisely because that depends on external factors such as the economy and competition. What we are dealing with here is a margin of safety, much like the margin of safety for avoiding aircraft accidents. When Wings Holdings says that NWA can support $3 billion of additional debt, they may well turn out to be correct. Ultimately it is cash which services debt, and Northwest has strong and growing cash flow. Nevertheless, their margin for error would be cut substantially. Standard & Poor's expects that NWA's senior debt rating will drop from BBB plus, which is low investment grade, to B, B plus or BB minus, which is speculative grade, if the LBO proceeds. That would leave Northwest in a better credit position than Pan Am, TWA and Texas Air, but in a considerably worse position than American, Delta, United and USAir. Following a Northwest LBO, more than a third of the industry's capacity would be provided by companies with speculative grade credit risk. If one or two of the remaining stronger airlines enters into an LBO, that proportion rises to half.

The implications go beyond risk to investors and employees. A bankrupt airline will probably be acquired, shrunk or liquidated. No matter which course is chosen, the likely effect is further consolidation of the industry. Strong airlines which have not undergone LBO's will have the resources to buy the assets of those who have failed. Even where that does not occur, aggressive competitors will move in to pick up extra traffic, as is happening now in Eastern Air Lines' markets.

Financially weak airlines are also likely to be more cautious about expanding and modernizing their aircraft fleets, particularly if the economy slows. The three speculative grade major airlines, Pan Am, TWA and Texas Air, account for less than $5 billion of the industry's $100 billion of orders and options. Except in the case of Texas Air's Continental subsidiary, all of these are airlines which have fleets that are older than the industry average.

At present these airlines can obtain aircraft by leasing or secured loans. Lenders are willing to finance equipment for such companies because they look to the collateral value of the aircraft. However, there is a price. Weak credits pay higher interest or lease rates. That means less aircraft per dollar invested. Furthermore, it is by no means certain that easy access to capital will continue if airline earnings and aircraft prices plunge in a recession. The ultimate question is whether an industry which needs to invest billions of dollars in new equipment can afford to dismantle its equity base. And what I have said about aircraft applies also to other investments which affect passenger service, such as employee training, terminals and other ground facilities.

In summary, airline LBO's have the potential to raise bankruptcy risk for a large portion of the industry, to accelerate an ongoing trend toward consolidation and to slow needed growth and modernization of aircraft fleets. Any complete evaluation of this phenomenon should include consideration of shareholder interests and other issues which I have not addressed. Nevertheless, the effect of airline LBO's on our Nation's air transportation system is cause for serious concern.

Thank you.

Senator Ford. Thank you, Mr. Baggaley.

Some questions I have could I guess be put to both of our witnesses to whom I am grateful for being here today. Let's start out with you, Paul.

What would happen to the air transportation industry if American Airlines, Delta, United, USAir are taken over by LBO investors?

Mr. Scura. Well, that's a difficult—those sorts of prognostications are very difficult.

Senator Ford. All our questions here are difficult. Our answers are sometimes not correct, but we need all the help we can get.

Mr. Scura. Well, if you agree with my opening statements that even highly leveraged airlines have continued access to capital through leases or through people who are prepared to lend against airplanes, then the ability of those carriers to continue to expand and buy airplanes would not be interrupted. Mr. Baggaley, on the other hand, says that he agrees I think that access to capital is relatively easy for airlines, even highly leveraged airlines, today, but if there is a downturn in the market or if used airplane prices start to decline, then that is not going to continue. That is clearly correct.

So, their ability to weather that sort of storm I think would certainly deteriorate if all of those three carriers went out and leveraged themselves highly. So, I think I would respond to your question that way.

Senator **FORD**. Mr. Baggaley, do you want to comment on that question?

Mr. **BAGGALEY**. Yes.

Senator **FORD**. He agreed with you.

Mr. **BAGGALEY**. Well, I would just add that in that situation, you would have pretty much the entire industry at some risk of bankruptcy in a serious recession. And we have seen the disruption that the bankruptcy of Eastern has caused, and Eastern is a relatively smaller carrier and one that has been shrinking for a while. You might well find yourself in a situation where the only buyers of all these extra aircraft would be foreign airlines because it is a world market for aircraft.

Senator **FORD**. Mr. Baggaley, you argue that the airline industry is not suitable for leveraged buyouts. Why then are apparently bright investors lining up with hundreds of millions of dollars to invest in this industry?

Mr. **BAGGALEY**. Well, there are two possibilities there. One is that they are simply making a mistake. And we will have to wait until the next recession to see whether that is true.

The other is that the interest of an LBO investor in making a return may not be exactly the same as the interests of creditors, employees and the traveling public.

Senator **FORD**. Mr. Scura, what effect would legislation like S. 1277, the one that we are discussing here this morning which would require Federal approval of future airline acquisitions, have on financing such transactions?

Mr. **SCURA**. Well, we would raise a question of uncertainty as to the doability of any particular transaction, but I do not think that it would act as a major deterrent to financial interests in the airline industry.

Senator **FORD**. Do you have anything to add?

Mr. **BAGGALEY**. Well, I think the proposed legislation, and let me say that I have not read the bill, so I am just going on your description, would——

Senator **MCCAIN**. Seize that opportunity please, Mr. Baggaley. I shall seize it.

It would discourage investment because it would raise uncertainty, and no one likes uncertainty. It might also cause potential acquirers to put up more equity in the deal than might otherwise be the case.

Senator **FORD**. Mr. Scura, you talked about three units of investors: the senior lenders, the mezzanine lenders and the equity. And you said I guess the senior lenders would get a normal return of what they would expect. The mezzanine would be up to 30 percent return, and the equity, 30 to 50 percent. If an equity investor was going to get 12 to 14 percent, would you be suspect of what that equity investor would be asking for or would be able to secure maybe down the road after the buyout was completed?

Mr. SCURA. There is no question in my mind, Senator, that for a mezzanine or an equity investor to accept a 12 or 14 percent rate of return, at least nominally in terms of the type of return on the security, that that investor would have to be looking for significant economic advantages through some other means, if it is through an operating agreement or through some sort of maintenance sharing program or some other significant advantage.

We did some calculations on KLM's investment in Wings' acquisition, and concluded that KLM would have to be looking for somewhere on the order of magnitude of $40 million to $60 million a year in incremental economic benefits derived other than through the coupons on the securities that they were buying in order to justify a rate of return of 30 percent on the type of investment that they have made there.

Senator FORD. So, you are telling me the possible objectives of a foreign airline could be a marketing agreement with a U.S. carrier or something similar to that?

Mr. SCURA. Some agreement that would allow them to pick up incremental traffic, for example, because of coordination of scheduling, some ability for them to capture revenues that they are not currently capturing in some way that may be going to a U.S. carrier where they are looking to divert traffic on to their system and pick up incremental revenues which would justify the investment from the rate of return basis.

Senator FORD. Are foreign investors, particularly foreign airlines, aggressively seeking to invest in U.S. carriers to your knowledge?

Mr. SCURA. Yes, they are. There is an article today about KLM in the Wall Street Journal which talks about the Northwest investment. It also points out that about 80 percent of the traffic that they carry originates outside of Amsterdam. So, they have a small base country with a small amount of domestic traffic and therefore have to look at the large markets that exist in North America and the Far East as a way of continuing their growth.

Senator FORD. Is it normal for a foreign investor to accept a lower rate of return on their investment or do they earn more than other investors?

Mr. SCURA. It certainly would not be prudent for an investor to accept a below normal rate of return on any type of investment, whether he is foreign or domestic.

Senator FORD. Since you have studied this question thoroughly, how does a marketing agreement supplement a direct financial investment?

Mr. SCURA. How would it work?

Senator FORD. Yes. How would it supplement a direct financial investment? You said that in this case you studied, it would have to be $60 million annually over and above the return.

Mr. SCURA. Yes, $40 million to $60 million. How would they get that?

Senator FORD. Yes.

Mr. SCURA. What I would envision—and there has been nothing stated publicly about it, but what I would envision would happen is that there would be a marketing agreement between the two carriers which would coordinate the scheduling of the two airlines in such a way as to allow traffic that would be originating on, let's say, the Northwest system to be carried directly over on to the KLM system at gateway cities that KLM serves here in the United States and try to grab as much of the traffic that was going across the Atlantic, the trans-Atlantic traffic, and flow it through KLM's Amsterdam hub system in Europe.

Senator FORD. Mr. Baggaley, do you have any comment on any of the questions I have asked Mr. Scura?

Mr. BAGGALEY. Well, let me make one comment on the issue of foreign investment. I think it is a sad comment that some of the few investors willing to make long-term investments in U.S. airlines are foreign companies. Like any other foreign investment, you would have to consider this on a case-by-case basis. It may well turn out that having a patient, long-term investor, if they do turn out to be that, is better than having your stock owned by arbitrageurs. But as I say, it is perhaps a somewhat sad comment on the sources of capital to U.S. airlines.

Mr. GREENBERG. Senator, can I add something to Mr. Baggaley's comment?

Senator FORD. Sure.

Mr. GREENBERG. When Prudential-Bach was assisting Pan Am putting to get our bid for NWA, we had discussions, abbreviated discussions, with KLM. We rejected including KLM in our capital structure and using their funds because we knew that they would demand a very onerous marketing agreement between Northwest, Pan Am and KLM which we believed would not be able to get regulatory approval. And, therefore, we did not include them due to the benefits that Mr. Scura outlined, the marketing maintenance and operating benefits of a foreign airline in the NWA transaction.

Senator FORD. Fine, thanks.

Senator McCain.

Senator MCCAIN. Thank you, Mr. Chairman.

Mr. Baggaley, in response to the Chairman's question about the legislation, Mr. Scura said that he didn't feel that that would act as a major deterrent to further acquisitions or financial activities in this area. And you said that it would raise some uncertainty. Is that correct?

Mr. BAGGALEY. Yes.

Senator MCCAIN. Is that good or bad?

Mr. BAGGALEY. Well, that is a hard question to answer. It depends on what seat you are sitting in.

Senator MCCAIN. As the Chairman said, there are no easy questions here.

Mr. BAGGALEY. I do not really think one could characterize it as being good or bad. It would perhaps weed out some highly leveraged acquisitions, but in general I think the free market is the most efficient allocator of capital over the long run. Whether it is in every single specific instance is another question.

Senator MCCAIN. Mr. Baggaley, I asked the previous witness about this philosophical aspect of this issue, and that is the threat of a takeover in order to improve efficiency. If that threat is removed, then obviously we then create an environment which would be conducive to the possibility of inefficient management, shareholders not getting the best return on their investment, et cetera.

How do you balance the concerns that you stated in your statement? You said if LBOs' spread through the airline industry, the result would be greater risk of bankruptcy, further consolidation and quite possibly slower progress, et cetera. How do you balance that eventuality which you stated and the removal of all threat of a takeover which then in the view of many might have the result which I discussed just a second ago?

Mr. BAGGALEY. Well, I think "balance' is exactly the correct word. There are a lot of considerations here. There is the threat of takeover, the shareholders' interest in getting the highest return on their investment and so forth. And it is a balancing act.

Now, my understanding of your proposed legislation is that it would certainly not remove the threat of takeovers entirely.

I think it is unfortunate perhaps that the most common means to exercise this threat of change of control has to be a leveraged acquisition. I think there is definitely a need for the threat of a change of control by some mechanism. However, this mechanism can in certain instances be damaging as opposed to, say, a change of management by a proxy contest or something of that sort.

Senator MCCAIN. Both you and Mr. Scura are very concerned about the penetration of foreign airlines into the United States airline industry. Now, they are free to go onto the stock market and acquire stock. Right?

Mr. BAGGALEY. Up to a certain limit.

Senator MCCAIN. Yes, up to a certain limit. I believe it is 25 percent.

Should we be preventing this acquisition up to 25 percent? If both you and Mr. Scura are concerned about the implications of significant involvement, should the Congress or the Securities and Exchange Commission act or the Department of Transportation act in order to prevent this kind of thing from happening?

Mr. BAGGALEY. Well, first of all, I would not totally agree with the characterization that I am very concerned about the penetration of foreign airlines. I think there are cases where it could pose a potential problem. There have also been cases where foreign companies have rescued U.S. companies that were in some financial difficulty, such as America West, an investment by Ansett. So, I do not think it is necessarily a bad thing. Of course, if you have the whole industry winding up 25 percent owned by foreign airlines, that would be a cause for concern.

Senator MCCAIN. Well, we are headed in that direction. When you look at 10 percent, SAS; 5 percent SwissAir recent purchase of Delta; 20 percent, JAL purchase of Hawaiian; SAS, Texas Air, 10 percent. British Airways are talking about involvement in United; KLM, 19 percent of Northwest; America West, 20 percent with Ansett. And all these are very recent events.

Mr. BAGGALEY. As some of the other witnesses have pointed out, there are strategic and marketing implications and motives for some of these. And depending on the market that could either increase or reduce competition. Again, I am forced to say it is a case-by-case situation.

Senator MCCAIN. Mr. Scura, do you want to comment?

Mr. SCURA. Yes. Senator, clearly it is a public policy issue. I know I spent a number of years financing the shipping industry. And there we have very strict citizenship tests as to who can own U.S. flag vessels. And if you look at the most recent acquisition that we are talking about today, the Wings' acquisition of Northwest, clearly the amount of foreign involvement in that entity would not be approved by the Maritime Administration in terms of the ownership of a U.S. flag vessel if it were a U.S. flag vessel we were talking about.

I do not feel qualified to talk about public policy as to whether foreign companies should be allowed to own U.S. flag carriers or not. I am just not qualified to do that. But it is a question that really needs to be addressed by public policy.

Senator MCCAIN. Are you familiar with the comparable status of the foreign airlines in terms of their debt to equity ratios, Mr. Scura?

Mr. SCURA. Not all of them, sir. You know, many of them are government-owned which makes the question just sort of moot.

Senator MCCAIN. Mr. Greenberg, are you familiar?

Mr. GREENBERG. No. I agree with Mr. Scura that it is moot to the extent that they are government-owned.

Senator MCCAIN. This booklet, Standard & Poor's Credit Week, is on airlines. Is it of interest, Mr. Scura, as we go through this that the highest credit ratings clearly are the five successful airlines, Delta, American, et cetera, and the lowest ratings—and many of them on credit watch, some with positive implications, some with negative implications—are those that are the most highly leveraged and are carrying the highest debt burden? I am stating the obvious, but doesn't that help you understand why we are very concerned about this situation?

Mr. SCURA. I certainly understand why you are concerned. I think the cause and effect, though, may be slightly different. The poor performance of those airlines historically over time may have given rise to their high leverage and therefore their deteriorated financial condition and credit quality as opposed to an entity like United or Delta which is a very well-run, high performing airline who perhaps could incur substantially more indebtedness than they presently have.

Senator MCCAIN. Mr. Baggaley states that if the takeover goes forward, Standard & Poor's expects that NWA senior debt rating will drop from BBB plus, which is low investment grade, to B or B plus or BB minus, which is speculative grade. There has been no change in the performance of that airline except that they were taken over and assumed about a $4 billion additional debt.

Mr. SCURA. Correct. I guess you are saying inherently it is bad if someone has a B plus or a BB minus rating as opposed to a BB plus rating. I am not so sure that you can say that.

Senator MCCAIN. I guess what I am saying is that, first of all, I think it is bad if the government intervenes without it being the absolute last choice. But I am also saying that it is bad if a company, an airline, acquires a major debt burden thereby reducing its Standard & Poor's rating which basically is only reflective of the risk of that airline being in serious trouble in the event of a recession. Those of us that sit on this side of the Chairman hope that we will never have a recession, and I am sure on that side of the Chairman as well.

Senator **Ford**. Thank you very much.

Senator **McCain**. But we also, with a cursory glance at the economic history of this country, recognize that there is going to be one at some point in time. Whether it is mild or severe is a question to which none of us knows the answer to, obviously, or we would be in your business. The fact is there will probably be a recession. And I believe Mr. Baggaley's ratings reflect the risk perhaps not in the best of time, but the risk in medium and the worst of time. And I guess I would seek your response to that.

Mr. **Scura**. Well, I think the question is whether the financial community can make a decision as to what is the appropriate level of leverage within the industry. And if the financial community is prepared to provide the necessary leverage to do a leveraged buyout of Northwest Airlines or United or Delta, whether they have the wisdom and the judgment and the ability to determine from a risk-reward standpoint whether that is a prudent thing to do or not, it's whether you allow the market to do it or whether it needs to be regulated. I mean, I believe that the market should do it.

Senator **McCain**. And from your standpoint, the legislation that Senator Ford and I have introduced may be helpful in perhaps providing some parameters for these LBOs without undue interference in the marketplace. Is that a correct assessment?

Mr. **Scura**. I would rephrase it just slightly, and I would say that I do not think it poses—it creates some additional uncertainty in terms of the LBO process, but I do not think that it would represent a major detriment to investors seeking to acquire airlines on a leveraged basis if that was a prudent thing to do.

Senator **McCain**. Mr. Baggaley, do you have any comment?

Mr. **Baggaley**. Regarding the Standard & Poor's ratings, as you said, they represent default risk and we do not say whether a rating is good or bad. It is just a measure of how risky it is, and presumably investors will demand a higher return for higher risk. Of course, there are wider implications of that bankruptcy risk.

Senator **McCain**. So, if there's a higher risk and the rating drops, that airline or that corporation is required to pay a higher return on investment because that investment is riskier. Therefore, they are required to generate more revenue in order to even stay even with where they were before.

Mr. **Baggaley**. That's correct.

Senator **McCain**. Thank you, Mr. Chairman, and I thank the witnesses. It has been very helpful.

Senator **Ford**. Two quick questions. Mr. Shane said earlier in his testimony that if an airline had some capital that could be invested, it could mean that they are not investing to their service to the public. Therefore, it does not necessarily mean that they are well-operated airline. Do you agree with that from your perspective?

Mr. **Scura**. By the mere fact that an airline is not highly leveraged does not necessarily mean that it is an extremely well-run airline. I agree with that statement.

Senator **Ford**. If under one of the LBOs you find that it is going to be difficult to meet your requirements for payments, and in order to streamline the entity or to have it produce additional profit, where would you first look as an investor to find larger returns for the money or less cost to operate the airline?

Mr. **SCURA**. You would do a combination of things simultaneously, Senator. You would certainly want to assure yourself that the airline was being run as efficiently as possible.

Senator **FORD**. What does that mean?

Mr. **SCURA**. Well, I think what that means is that you are maximizing revenue to the greatest extent that you possibly can and you're providing a service at the lowest possible cost that you can. If the situation was a dire one, you would seek relief from your senior bank lenders and from other scheduled debt lenders to stretch out the payments on those loans so that you would not go into default. You would seek to do a combination of those things to ensure the ongoing viability of the airline.

Senator **FORD**. But you are talking about your creditors now, in dealing with the creditors.

Mr. **SCURA**. Yes, sir.

Senator **FORD**. But you are operating the airline. And you say you get everything necessary from your creditors, the extension of time, resale or whatever you might do. But what would you do within the company to help produce more revenue to pay your creditors?

Mr. **SCURA**. As I said, you would certainly try to make sure that the airline was being run as efficiently as possible.

Senator **FORD**. When you run it efficiently, what do you do? If you need more money, do you look at your employees and if you have too many, or do you go to them and ask them for a reduction in the hourly rate?

Mr. **SCURA**. You have done that. That has been done before in the past, and that is certainly something that you would consider doing, yes.

Senator **FORD**. So, we look at all four of the major airlines and we are saying to those employees there once we take it and things don't turn out right, you are going to have to take a salary cut. That is the first thing you are saying to them down the way. That bothers me a little bit.

But then instead of having X number of maintenance people, we just need Y number of maintenance. That shakes this Senator some because that means you either work longer to carry out the maintenance of the airplanes. Your investigators that oversee or your superintendents that oversee—instead of having five, you will just have four at an airport or something. Does that indicate to give confidence to the traveling public?

Mr. **SCURA**. That's a question to me?

Senator **FORD**. Yes.

See, you are out here with all this money business. You want to make that money safe. I am flying the mother. I want you to know that.

Mr. **SCURA**. So am I.

Senator **FORD**. And I wanted to be sure that it stays up and the wings don't come off.

Mr. **SCURA**. Well, I would respond to that by saying that it has been shown that well-maintained airplanes are an extremely good investment for the airline. I hate to keep using the example of Northwest, but Northwest maintained its airplanes very, very well. And consequently, the amount of borrowing that one could do against that fleet, because it was a very well-maintained fleet, and the value of that fleet was enhanced as a result of that good maintenance program that they had. So, the amount of maintenance that is put into the maintenance of the fleet, et cetera, is a very good investment for an airline to make. So, I am not so sure that they would cut maintenance.

Mr. **Greenberg**. In fact, Senator, a continued high maintenance program can allow them, after the fact—as Mr. Baggaley indicated, Northwest had a low number of leases—to go out and sell their planes and lease them back to raise additional cash.

Senator **McCain**. You know, we are not as concerned under present economic conditions as to whether they would cut maintenance. What we are worried about is if there is an economic change and they have certain fixed costs. And, of course, all this is overseen by the FAA. They are not going to just let them get away with shortcuts and procedures, but we have seen in the past that the FAA, although extremely efficient and effective, is somewhat limited. I think that is an area that we are concerned about. Isn't that right, Mr. Chairman?

Senator **Ford**. Absolutely.

We have taken too long. And just let me thank you three gentlemen for coming. Mr. Scura, is was short notice, and I think you performed adequately here this morning; in fact, above anything we expected. And we are very pleased with the——

Mr. **Scura**. I don't know whether that is good or bad, Senator, but I take it as a compliment.

Senator **Ford**. Well, what I am saying is that you have come forward with knowledge and honesty and that is more than we expect from most everybody.

Mr. **Scura**. Now I know whether it is not a compliment.

Senator **Ford**. And, Mr. Baggaley, we want to thank you too. I understood you cut your vacation a little short to come and be with us this morning. And Senator McCain and I are grateful to you both for coming. We will be probably sending some questions for some written answers. If you could accommodate us, we would appreciate it. You are in the swim now here and part of the future and what we do here will be based on your testimony this morning. And I want you to know that you will be an integral part of what we do. I am personally grateful to all three of you for coming this morning. We do thank you.

Mr. **Baggaley**. Thank you, Senator.

Mr. **Scura**. Thank you.

Senator **Ford**. The next witness will be Captain Henry Duffy, President, Air Line Pilots Association, International. Captain, if you would come forward. This is no new place for you.

Senator **McCain**. Captain Duffy, before we begin, when do you have an opportunity to fly?

Mr **Duffy**. Not lately. Only in the back I'm afraid.

STATEMENT OF HENRY A. DUFFY, PRESIDENT, AIR LINE PILOTS ASSOCIATION

Mr. DUFFY. Well, thank you, Mr. Chairman.

The 41,000 pilots that ALPA represents for 46 airlines believe that this bill hardly could be more timely and ALPA supports it completely.

Early this year Northwest Airlines was, in the jargon of Wall Street, put into play. Confronted by two proposals by non-airline entities to acquire it, the airline was essentially compelled to put itself up for bid. Following two rounds of bids, Northwest's board of directors in June agreed to execute a merger agreement with Wings Holdings, Inc., and recommended that stockholders accept the Wings bid.

The events at Northwest have now apparently put every financially sound major carrier into play. In early June, Julius Maldutis, a prominent airline analyst for Salomon Brothers, issued a report entitled "The Airlines—Valuation of Airline Mergers and Acquisitions" which included and estimation of the current private market values of several major airlines. According to Mr. Maldutis, the efforts to take over airlines is likely to continue.

This sentiment was echoed by Morgan Stanley's airline analyst, Kevin Murphy, who in a lengthy interview in last week's Barron's opined that most major airline stocks are exceptionally good buys in light of the current intense takeover interest. Over the past month, United has experienced a remarkable run up in its stock price based on takeover speculation while Delta has just announced that it is establishing an employee-stock ownership program and selling additional stock to Swissair, moves plainly designed to prevent a takeover.

Thus, the airline industry seems poised for a round of restructuring that may rival the almost unbelievable activity of 1985 and 1986 when more than 15 mergers and acquisitions occurred. I can tell you, as a representative of many of the employees affected by those and many other business deals that followed in the wake of deregulation, that they created real hardships and uncertainties for those individuals. But those hardships are likely to pale compared to what may be coming absent intervention by the Congress.

The next round of takeovers and subsequent restructurings of airlines is likely to be qualitatively different from what we have experienced so far. The last round, with a couple of prominent exceptions, involved acquisitions of airlines by airlines where the goal was to strengthen the ability of the surviving carrier to grow and prosper in the new competitive environment. But, as you noted in introducing this bill, the current round of activity may be spurred on not by persons with a long-term stake in the aviation industry, but by Wall Street vultures.

Now, I am certainly not including Mr. Checchi and his partners at Wings Holdings in that category. Mr. Checchi has gone out of his way to express his good intentions towards Northwest Airlines and its employees. But his acquisition of Northwest will add more than $3.3 billion of debt to that airline, and that raises the very concern that motivated the introduction of S. 1277. What will happen to a highly leveraged airline in an economic downturn?

Will its management sell off assets, cancel equipment orders, delay safety improvements? We don't know, but certainly common sense tells us that some or all of those options are likely to be exercised and that employees and consumers are likely to suffer. So, what we need is precisely what you and Senator McCain have proposed: a mechanism to review airline acquisitions before they take place to examine what effect they might have on an airline's long-term competitive potential.

Even the Wall Street analysts I have quoted and whose comments I have submitted with my testimony believe the forced financial restructuring that appears imminent will be bad as a matter of public policy. Thus, Mr. Maldutis says that "this restructuring process, which maximizes stockholder value over the near term, is not healthy for the industry as a whole because of the high capital requirements of the airline industry is now facing to modernize its aging aircraft fleet."

Mr. Murphy is even blunter. He says—and I quote—"My feeling is that to do these things to American industry"—that is, to maximize asset value to achieve short-term stock increases—"and the way it affects society—is somewhat shameless. I would try to keep restructuring out of the airline industry, because I really do think that the consumer in the long run, and labor, in the long run, are going to be hurt by less compelling service and higher fares." Mr. Murphy I believe is right on target.

But then he goes on to say—and I quote again—"The regulators probably should do something, although my guess is that they probably won't." Here I hope that he is wrong, though I am afraid that without direction from Congress, he may again be right.

Now, Secretary Skinner has suggested that DOT is going to subject airline business transactions to a heightened review. And, indeed, he has made a substantial request for information in the Wings-Northwest proposal. But the principal tool he has to work with is the continuing fitness requirement in the Federal Aviation Act. That is a weak tool. Therefore, though Secretary Skinner may be well-intentioned, I am skeptical about his ability to actually block a potentially damaging transaction under current law.

Furthermore, any effective review of acquisitions under that law would depend on an aggressive DOT exercising its discretion to assert implicit rather than explicit review authority. An aggressive DOT can quickly lapse into a passive one.

The most recent articulation of the Department's policy with respect to continuing fitness reviews came from Mr. Skinner's predecessor who determined that the economic condition and management of a carrier were not of concern as long as they did not compromise safety.

Accordingly, ALPA believes this bill is an important and necessary measure to ensure that airline acquisitions receive appropriate and consistent review to determine whether they are in the public interest. Indeed, it is a measure that even Wall Street analysts apparently believe is necessary.

ALPA also believes that the bill should be expanded to require that labor protective provisions be afforded employees adversely affected by airline acquisitions. As you know, Mr. Chairman, the DOT abandoned the Civil Aeronautics Board's longstanding practice of imposing LPPs in airline acquisition cases even though both Houses of Congress passed LPP measures. Airline employees were thus left unprotected throughout the wave of recent mergers. We know what that was like, and there is every reason to believe that acquisitions by takeover artists from outside the industry could be even more devastating to airline employees.

ALPA also believes that the bill should contain an exclusion for buyouts where a significant portion of the stock will be owned by the airline's employees. Such an exclusion is appropriate because employee buyouts do not raise the types of concerns that generated 1277. Airline employees are plainly into their companies for the long haul and would reduce a carrier's operations or sell assets only as a last resort.

In sum, ALPA agrees wholeheartedly with you, Mr. Chairman, when you described the airline industry as a national asset. Our jobs and livelihoods are tied to the fate of that industry. We don't get much pleasure when, in the sporting language of Wall Street, our employers are put into play. Too often in such play, the losers are not the players, but the bystanders or the object of the game itself. The airline industry is imbued with the public interest and Congress should make sure that the rules of the game restrain play that is destructive of that interest. Thus Congress should enact this bill with the modifications I have suggested to ensure that air carrier acquisitions are rigorously reviewed to determine, in advance, whether they are in accord with that public interest.

Thank you, Mr. Chairman.

Senator **Ford**. Thank you, Captain Duffy.

We heard earlier from General Humphrey, the Attorney General of Minnesota. He asked for two or three additions to the bill. You probably have not had time to look over those recommendations, but I would ask that you do that and let us have the comment of ALPA on his recommendations.

Mr. **Duffy**. Yes, sir, we will.

Senator **Ford**. And you also I'm sure listened earlier this morning. The Department of Transportation asked that we do not take any action on S. 1277 until their review of the leveraged buyouts is complete. Given your support of the bill and your concerns, would it be an adequate approach for us to wait till the first of November or next year before we get on with this legislation?

Mr. **Duffy**. Mr. Chairman, we read the analysts and the tea leaves and all the financial information we can get for this industry. We think the heart of the industry, the financially sound carriers are at great risk here, and we think as a matter of timeliness, that this bill needs passage as early as you can accomplish it legislatively. If we weaken the financial core of the industry—there are already enough cripples out there as it is, but if we weaken the financial core, I have grave concerns about its impact, of course, on the employees, but on the safety of the aviation industry.

Senator **Ford**. If we incorporate your suggestions by providing additional criteria concerning wages and working conditions, the LPP position, as part of the review, do you have any concerns that it might block future acquisitions? Really, I do not know whether it makes a whole lot of difference whether we block them or not. The good airlines that are running and making the world fly I'm not sure we would block. It bothers me considerably. But would this particular item, you think, have any more play on blocking the acquisition than any of the others?

Mr. DUFFY. Well, our proposals on labor protective provisions called on the Secretary to simply evaluate the impact that the LPPs would have on a takeover. For instance, we recognize that in some cases where a crippled carrier were being acquired, there may be other considerations there for the survival of that carrier.

But what has happened, at least in the last administration, was that they simply took an attitude that labor protective provisions were not necessary. They were something that we should have negotiated contractually which was fine except that when we were negotiating all those contracts in past years, the Civil Aeronautics Board has as a matter of policy imposed the labor protective provisions. So, we didn't put those provisions in our agreements. But for the Department of Transportation to have simply turned its back on the employees in this industry, we do not feel is right.

Senator FORD. Captain, we have discussed some here this morning about foreign investment. Under current law, foreign entities are precluded from owning more than 25 percent of a certificated U.S. airline. Do you see this position as adequate, or do you think we ought to look at revision of that?

Mr. DUFFY. I think that is an issue ripe for hearings, Mr. Chairman, and perhaps a GAO study. I am concerned with the globalization of the airline industry. Of the subtle pressures that could be put on an airline, 25 percent is substantial. And while in the past there was not a lot of this activity, you can just see it starting to snowball now and we are going to see a lot more of it.

I think the subtle pressures in influencing marketing decisions of our domestic carriers or perhaps influencing the bilateral positions of this country through the lobbying of our domestic carriers because of the external influence has great potential and perhaps negative potential to this country. And so, I think it is a matter of utmost importance and, as I say, I hope that we will get substantial hearings on it and perhaps a good study by the GAO.

Senator FORD. Well, I think your suggestion about the GAO study is on target, and it may cause us to revise our current policies to better evaluate the growing trend. I mentioned 1992. I think that has something to do with the Common Market when it becomes one. And everybody is poised to make big moves and that sort of thing. And I am afraid that maybe some of the foreign carriers, which are country-owned and not company-owned, might start eating our lunch when we start dividing up routes and that sort of thing in the future.

Mr. DUFFY. Mr. Chairman, that is our concern. This market in this country is the plum of the world. We hear cabotage everywhere we go in foreign countries to talk to their aviation interests. They are looking at this market and licking their chops and they can't wait to get at it. And the 1992 activity is going to bring that on strong.

If we have an enemy within, so to speak, it is substantial foreign ownership of our domestic carriers. It is going to weaken the ability of those domestic carriers to stand up for their own rights and therefore the public interest rights of the United States carriers.

And so, again, our concern is that we will be undermined by that foreign ownership.

Senator FORD. We are on the same wavelength. I hope we can come with something fairly quickly that will be adequate.

Senator McCain said if he wasn't back, we could stop. And so, he isn't back. Do you have anything else you want to add, Captain?

Mr. DUFFY. No, sir. Again, this bill needs expeditious consideration and passage by the Congress. It is a necessary bill.

Senator FORD. We will do the best we can.

This hearing is adjourned.

[Whereupon, at 12:05 p.m., the subcommittee was adjourned.]

ADDITIONAL ARTICLES, LETTERS, AND STATEMENTS

STATEMENT OF HON. BYRON L. DORGAN, U.S. REPRESENTATIVE FROM NORTH DAKOTA

Mr. Chairman, the potential for a heated contest of airline takeovers could endanger our transportation industry, disrupt airline service to rural states, and fan the flames of merger mania already licking at our entire economic house. So I commend you for calling hearings on airline debt and takeovers, a subject which has received too little attention in Congress.

I have introduced legislation that would attempt to discourage hostile takeovers and leveraged buyouts in the airline industry. My bill, H.R. 2354, focuses on the major airlines and the airline industry because I fear that putting major airlines in America "in play" in this game of speculation as practiced by the fast buck artists will seriously damage airline companies that so many people rely on for their transportation needs.

PROVISIONS OF H.R. 2354

Let me briefly summarize the main provisions of the bill.

Interest deductions from income tax for junk bonds and other debt incurred in hostile takeovers are prohibited.

More specifically, my bill would deny the interest deduction for indebtedness exceeding $100 million incurred for stock acquisition in a major airline where the stock acquisition is accomplished by a hostile offer or with indebtedness consisting of junk bonds, or where the debt/equity ratio of the targeted company following the transaction is greater than one to one and such ratio is increased 50 percent or more as a result of the change.

My purpose, then, is to help stop hostile or highly-leveraged takeovers of major airlines with junk bonds and to prevent healthy airlines from becoming loaded down with the dangerous levels of debt.

Placing our major airline companies in the middle of this speculation game is dangerous and counter to the public interest. For one thing, it encourages the willful takeover of healthy companies merely so that a handful of investors can reap short-time gains. For another, the enormous debt involved in takeover bids imperils the financial stability of the airline itself. Consequently, the company may be forced to raise ticket prices and curtail service to rural areas like North Dakota.

May I also underscore that airlines are particularly susceptible to failure because of cyclical swings, enormous capital requirements, and highly variable cash flow conditions.

HEAVY DEBT LOAD IN NORTHWEST TAKEOVER

I am particularly concerned about the recent takeover of Northwest Airlines. I have met with the new owners, a group led by Alfred Checchi. I believe that Mr. Checchi is sincere in his desire to expand Northwest and to retain service in its current markets.

However, I am deeply concerned that the imposition of $3 billion of additional debt on the company—with added interest payments of some $300 million per year—could jeopardize Northwest's credit standing, force service reductions, and prevent the acquisition of a new fleet of aircraft needed to keep the company competitive.

Expert airline analysts have voiced similar concerns. Philipp Bagley, Vice President at Standard Poor, has told my staff that Northwest's bond rating could slip several notches as a result of the takeover. This could take Northwest out of the class of financially strong airlines like United and American and put it in the same league as weaker companies like Texas Air and TWA. Obviously, such a change would raise grave concerns to passengers and shippers in a region dominated by Northwest Airlines.

However, I do not limit my concern to Northwest alone. In the past few days a bidding war has sent the stock of United Airlines soaring as yet another solid airline has become the object of the takeover game. I worry that this is only the start of a trend which will continue unless we take some bold and innovative steps.

FURTHER ACTION NEEDED

I have met with Transportation Secretary Samuel Skinner to express my specific concerns about the Northwest buyout. I urged him to use every available authority to intervene to prevent healthy airlines from becoming pawns in a takeover game and to help safeguard service to areas like the Upper Great Plains which depend so heavily on regularly-scheduled and reasonably-priced air service.

My impression is that these takeovers also trouble Secretary Skinner, but that he doesn't feel that his existing statutory authority gives him full power to deal with the emerging threats to the airline industry. I am also troubled by the track record of both the Transportation and Justice Departments in the past eight years—a record which shows an unwillingness to see that the fitness of air carries is not impaired by takeovers or to exercise antitrust authority to prevent detrimental corporate mergers.

For these reasons, I would urge the subcommittee to consider additional legislative remedies, including the bill which I introduced with seven House colleagues.

Let me make one other observation about these hostile takeovers in general. Those who support such activities say that hostile takeovers represent the takeover of "underperforming" companies and turn them into better companies. The record shows that's not the case. Professor Lewis Lowenstein, in a study, demonstrated that the targets of these takeovers have largely been companies performing slightly above average before the takeover and performing below average after the takeover.

I think it's time to tell the speculators that we won't allow them to take apart our transportation companies in order to make a quick buck, especially if it will have a dramatically negative impact on the customers those airlines serve. That's why I've introduced my bill, H.R. 2354, for discussion here in Congress.

Let me reiterate that interest deductions should be denied where indebtedness exceeding $100,000,000 is incurred or continued for stock acquisition in a major airline and (1) where the stock acquisition is accomplished pursuant to a hostile offer or with indebtedness consisting of "junk bonds" or (2) where the debt/equity ratio of the target company following the transaction is greater than 1 to 1 and such ratio is increased 50 percent or more as a result of the change.

SUPPORT THE PUBLIC INTEREST

Congress cannot afford to ignore the costs associated with hostile mergers and leveraged buyouts that threaten the economy stability of our major commercial airlines, in exchange for exorbitant short-term profits gained by corporate raiders.

So whatever the intentions of airline buyer, let's ensure that we protect our economy and airline consumers. I welcome the opportunity to cooperate with the chairman and members of this panel in achieving that goal.

STATEMENT OF JOHN F. PETERPAUL, VICE-PRESIDENT, TRANSPORTATION INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS

My name is John F. Peterpaul. I am Vice President of Transportation for the International Association of Machinists and Aerospace Workers ("IAM") and have held that elected position since December 1, 1973. The IAM represents approximately 800,000 employees in various industries throughout the nation. We are the largest union in the air transport industry, representing 95,000 mechanics and related employees. As a union intimately involved in the airline industry, the IAM welcomes this opportunity to testify before the Committee and voice our concerns regarding the dangers posed by leveraged buyouts ("LBOs") within the airline industry.

We of the IAM have seen first-hand the often devastating consequences of unchecked corporate avarice on the travelling public and airline employees. Since the Airline Deregulation Act of 1978, mergers, hostile takeovers, leveraged acquisitions and bankruptcy have all served to establish an environment in which airline management has resorted to the economic law of the jungle. The IAM concurs with Professor Frederick C. Thayer of the University of Pittsburgh, that "the dog-eat-dog competition unleased by . . . economic deregulation . . . forces many if not all companies to cheat and cut corners in ways that are dangerous to their customers, society at large and even themselves." *New York Times* (2/23/86).

LBOs are the most recent, and potentially most devastating, trend among corporate raiders who care little about running airlines, and even less about their workers. All too often, the net result is not increased competitiveness or expansion, but a heightened risk of bankruptcy, further concentration within the industry, the loss of jobs and reductions in wages, and the paring of the expenditures for maintenance, employee training and fleet moderation.

The Texas Air Corporation provides the most poignant example of the nature and consequences of LBOs in the aviation industry. Mr. Lorenzo's capture of Continental and Eastern loaded these two airlines with what they needed least—more debt—and they now rank as the lowest grade of credit risk among all major airlines. As the *Wall Street Journal* (4/7/88) observed, "Mr. Lorenzo has built one of the most leveraged major corporations in the nation while insulating Texas Air—and himself—from most of the cost and most of the risk[.] Mr. Lorenzo presides over some of the nation's sickest airlines[.] All are losing money at some of the fastest rates in aviation history and rank as the industry's biggest debtors. As a group, the Texas Air companies have piled up $5.4 billion in debt. Last year they had to pay $623 million simply to service the long-term part of that debt—an interest bill higher than the annual revenue of each of narly 100 companies at the bottom of the Fortune 500."

Because of the cyclical nature of airline economics, LBOs pose a direct threat to the public interest in the form of increased risk of bankruptcy. At present, we face the possibility of an economic slowdown which would hit hardest at heavily leveraged airlines. Two years ago, *Aviation Week & Space Technology* (10/6/87) warned that "Economic shock waves would increase operating pressures on U.S. Airlines . . . and could serve as a catalyst for a final round of airline consolidation, in which economically weakened airlines would be acquired or merged into stronger partners". In an industry dominated by six megacarriers (Texas Air, United, American, Delta, Northwest/Republic and TWA) which control almost 80 percent of the industry's market share, the loss or financial crippling of just one of these airlines would mean further increased concentration and reduced competition.

The argument that LBOs contribute to a more efficient use of capital is certainly not intuitively obvious, and, I suggest, contradicted by experience. Corporations with highly leveraged financial positions, especially in capital intensive industries like airlines, most reduce expenditures in order to service their debt burden.

Mr. Paul Stephen Dempsey, Professor of Transportation Law at the University of Denver College of Law, supports our ("MEL") and the company's maintenance programs. Problems arise when carriers see the MEL as a way to reduce maintenance costs. Eastern has taken the lack of FAA time requirements on the repair or replacement of "open items" to an extreme, ranking worst in open MEL items per plane per day (1.4) and deferred MEL items per aircraft (average 55).

Such problems are further compounded by the pressing need to modernize rapidly aging commercial fleets as airlines with diminished capital become increasingly dependent on older planes to meet expanding needs. According to *Aviation Daily* (6/2/88), at the start of 1988, 25 percent of domestically registered jet transports are 20 years old or older and more than 45 percent of the total aircraft in operation are at least 15 years old. Philip Baggaley, an airline bond analyst for Standard & Poor's, stated that a takeover which piles on a company's balance "is very risky for airlines [because] it diverts resources away from fleet modernization, which is a huge problem, or challenge, at Northwest and every other airline. If you have a weaker financial position, you are more hesitant to go forward with buying new capacity (aircraft) and, if you do, you have to pay more for it." *Aviation Daily* (6/23/89).

The IAM urges the prompt passage of S. 1277 as an initial step towards preventing the further erosion of the safety margin within the airline industry. Senator Ford and Senator McCain's legislation would further this goal by imposing an obligation observation: "One of the dangers of poor or nonexistent profits for an industry such as transportation is the natural tendency of management to curtail costs; among those which can be significantly diminshed are maintenance costs, including spare or replacement parts and idle vehicle time lost during inspection and maintenance." Over the past nine years, labor and safety-related costs, including training and maintenance inspections, have been the areas most often selected for cost reduction because their effect can be temporarily concealed.

Since the advent of deregulation, the airline industry has witnessed a substantial increase in commercial flights and a decreasing number of mechanics to service an aging fleet. Debt-ridden airlines have slashed their staff of maintenance training instructors and terminated hundreds of mechanics and related workers. In Eastern's case, this reduction occurred when the airline was under increased scrutiny for safety violations. Eastern's subsequent $9.5 million dollar fine, the largest penalty ever collected by the FAA, and the huge maintenance fines levied against Pan Am and Continental, are suggestive of deep rooted problems among airlines faced with high debt burdens.

Distressed airlines, faced with increased pressure to cut costs, have all too often resorted to reductions and deferral of maintenance in order to stretch out expenditures. One example is the reliance on the FAA directive which permits airlines to defer maintenance through reliance on the Minimum Equipment List upon the Secretary of Transportation to make a determination that an acquisition "will not adversely and materially affect a carrier's fitness". S. 1277 establishes an appropriate framework for the Department of Transportation's approval or disapproval of the transaction. Such a legislative imperative is necessary in view of the Department's traditional hands-off approach to mergers and acquisitions in the decade since deregulation of the industry. Without this timely legislation, the safety of our air travel is imperiled by economic predators whose only objective is the amassing of the greatest possible with scant regard for legitimate public interests in safe and reliable air transportation.

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